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Supreme Court of the United States

October Term, 1974
No. 74-799

UNITED STATES OF AMERICA,

Petitioner,

vs.

FOSTER LUMBER COMPANY, INC.,

Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit.

Brief of Data Products Corporation, as Amicus Curiae, in Support of Foster Lumber Company, Inc.

HILBERT P. ZARKY,
1800 Century Park East,
Los Angeles, Calif. 90067,

BORIS I. BITTKER,
445 St. Ronan Street,
New Haven, Connecticut 06511,
Counsel for Data Products Corporation.

Of Counsel:
MITCHELL, SILBERBERG & KNUPP,
1800 Century Park East,
Los Angeles, Calif. 90067.

Parker & Son, Inc., Law Printers, Los Angeles. Phone 724-6622

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Brief of Data Products Corporation, as Amicus Curiae, in Support of Foster Lumber Company, Inc.

The Interest of Data Products Corporation, Amicus Curiae.

Data Products Corporation will be directly affected by this Court's decision in the present case. The Court of Appeals for the Ninth Circuit, considering an identical issue, affirmed a summary judgment of the District Court, holding that Data Products Corporation was entitled to a refund of taxes in excess of $150,000 for the year 1970. Affirmance by this Court of the decision below in the Foster Lumber Co. case will not only lead to affirmance of the decision of the Court of Appeals for the Ninth Circuit, but it will also confirm the right of Data Products Corporation

to apply more than $5,000,000 of unused carryback losses against the taxes that would otherwise be imposed on its business income in other years—an application which would be completely lost if the views of the government were to prevail.

The United States has filed a petition for a writ of certiorari to review the decision of the Ninth Circuit in favor of Data Products Corporation (No. 74-996, October Term, 1974). This Court has not acted on the petition.

Recognizing the direct interest of Data Products Corporation in the issue to be considered by this Court in the present case, the United States and Foster Lumber Co. have each consented, in writing, to the filing of a brief *Amicus Curiae*.

Question Presented.

Foster Lumber Co., the taxpayer, incurred a business loss in the year 1968. In accordance with I.R.C. Section 172(b), a portion of the loss served as a deduction to reduce the corporate income tax on its ordinary business income earned in 1966. During the year 1966, the taxpayer also had a capital gain, the tax on which was determined under the so-called alternative method prescribed by I.R.C. Section 1201(a); no part of the 1968 net operating loss served to reduce the tax on the taxpayer's 1966 capital gains.

The question is whether the court below was correct in concluding that the portion of the 1968 business loss, not deductible in prior years and not deductible in computing the 1966 tax on capital gains, was still available as a deduction against the corporation's 1967 business income.

Statute and Regulations Involved.

The pertinent provisions of the statute and Treasury Regulations involved are set forth in Appendix A, *infra*.

Summary of Argument.

1. Where a business loss is incurred, it is available as a deduction against the business income of another year under the net operating loss provisions of §172 of the Internal Revenue Code. The court below correctly held that such loss has not been "carried" to an earlier year when there was a capital gain taxed at a flat rate under the alternative tax and that, consequently, the loss is still available as a deduction in the year of ordinary business profits.

Specifically, under the decision below, the business loss which Foster Lumber Co. experienced in 1968 was, for the most part, available as a deduction, to offset the business profits of 1967. Contrary to the government, the 1968 loss had not been "carried" to 1966 (except to the extent that there was a small amount of business income in 1966) when there was a capital gain subject to a flat rate of tax, since all agree that the tax on such capital gain was not reduced by the existence of the 1968 loss. Consequently, it was still available in 1967.

2. The court below, which applied principles long followed by the Tax Court, was correct in its construction of the statute and in rejecting the contention that there could be a deduction which did not result in a tax benefit, which is the theory espoused by the government. The decision of the court below is not only warranted by the language of §172(b)(2) (even though the statute is capable of more than one construction)

but is buttressed by every existing aid to ascertaining the legislative intent. The government, in urging a contrary construction, points to little, aside from the words of an ambiguous Code Section, to justify the conclusion that the statute achieves only an abstract objective of reducing taxable income, rather than a meaningful result of reducing taxes; what little it relies on is demonstrably wrong.

3. The decision below gives substantive meaning to §172(b)(2), for it carries out the announced congressional policy that underlies all of §172, namely, an averaging of the tax burden where business results are sporadic and putting competitiors on an even footing, even though the income of one is more volatile than that of another. It also gives simultaneous effect to the congressional policy which views capital gains as being separate from ordinary business earnings, and believes that the economy can best be served by taxing these two kinds of income differently. The legislative history, moreover, confirms the conclusion that both policies were intended by Congress to be adhered to, rather than having one of them being undermined, as would be true if the government's view were to prevail.

4. The decision below results in §172(b)(2) being applied in a meaningful way, *i.e.*, affording a deduction which results in a tax reduction, rather than having it serve only as an abstract deduction from taxable income in some work sheet, which is never reflected in the form of a tax benefit. The assumption of the court

below that Congress was acting substantively, not purely formalistically, accords with well settled principles.

5. The decision below applies the statute so that sheer accidents of timing do not control the ultimate tax results and it avoids the curious consequence which would follow under the government's view where a reduction in tax depends upon the happenstance of which came first—the capital gain or the business income. §172(b)(2), as interpreted by the court below, results in a uniform tax burden regardless of this particular sequence, which becomes irrelevant, as it should. It also avoids the bizarre result, which would otherwise follow under the government's thesis, where a later capital loss would not only eliminate a prior tax on capital gains, but would also eliminate a prior tax on business profits—the latter results being contrary to the expressed intention of Congress.

6. The one available insight into the administrative practice reveals a construction of §172(b)(2) which is contrary to the present litigating position of the government. Indeed, during a period of more than thirty years, when they could have done so, the Treasury Regulations have never expressed the conclusion only recently adopted as the government's litigating position. Further, aside from whether the government has ever disclosed that position to Congress, the fact is that Congress, despite the opportunity to disavow the Tax Court's view of the statute (which was also the view embraced by the court below), not only failed to do so but

achieved a parallel result when it enacted capital loss carryback provisions for corporations in 1969.

7. Since the ultimate issue depends on an interpretation of narrow, technical provisions of the Internal Revenue Code, and does not require the applicability of broad, basic principles in the administration of the tax law, the federal courts should rely heavily on the expertise of the Tax Court which is constantly immersed in all the details of the taxing statute. If the Court of Appeals for the Fourth Circuit had relied more heavily on what the Tax Court had already, and repeatedly decided, the present conflict in decisions would not have arisen and there would have been no occasion for this Court to decide the particular, narrow problem here presented.

8. The government is wrong in contending that the court below gave "taxable income" in §172(b)(2) a different meaning than is its definitional meaning in §63(a). Neither it nor the Tax Court did so. Actually, it is the "carried" language of §172(b)(2) which leads to the conclusion that a net operating loss has not been carried to a year when it does not reduce the taxable income on which the tax is imposed. The government's argument also embraces other erroneous premises, such as (a) that Congress intended parallel treatment for the loss year and the years to which a loss is carried, (b) that the decision below would result in better treatment for corporations than for individuals, and (c) that there is an improper pyramiding

of benefits when the Internal Revenue Code is applied in such a way as to give effect to two different policies for which Congress has made separate provision.

— — —

9. In the event that this Court should reverse the decision below, we urge that there be a reconsideration of one of the premises assumed by the court below, and on which the Tax Court has traditionally proceeded, namely, that a net operating loss does not reduce the amount of capital gains or the tax thereon, where the alternative tax is used. We contend that if the government's position is adopted and this Court holds that a net operating loss has been carried to a year where there are capital gains subject to the alternative tax, the premise that the tax on such capital gains is not reduced by the net operating loss can no longer survive.

ARGUMENT.

I.

A Corporation's Business Loss, Allowable as a Net Operating Loss Carryback Under Section 172 of the Internal Revenue Code of 1954, Has Not Been "Carried" to a Taxable Year to the Extent That It Does Not Reduce the Taxpayer's Income Subject to Tax and Does Not Lessen the Tax Liability for That Year; Hence, the Loss Remains Available for Use as a Deduction in the Following Taxable Year.

A. Introduction.

The question before the Court involves an interplay between two provisions of the Internal Revenue Code of 1954—§172, permitting taxpayers to carry a business loss from the year of the loss to certain other taxable years, where it may be used as a deduction; and §1201, imposing an "alternative tax" on taxpayers with net long-term capital gains[1] if the tax so computed is less than the tax computed under the regular method. Each provision reflects distinct congressional policy decisions regarding separate problem areas in the tax law.

Although the statutory provisions are complicated, the issue itself can be phrased in simple, nonstatutory language. Foster Lumber Co., the taxpayer before the Court, suffered a business loss of about $42,000 in

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[1]Like the government (Br. p. 15, n. 5), we use the term "net long-term capital gain" as a convenient substitute for the more cumbersome statutory phrase, viz., the "excess" of "the net long-term capital gain" over "the net short-term capital loss." See §1201.

Except where indicated, statutory references are to the Internal Revenue Code of 1954, as amended.

1968. It carried that loss back to 1966, a year in which it had business income of about $7,000 and net long-term capital gain of about $167,000. The 1968 business loss was applied in 1966 to wipe out the taxpayer's $7,000 of business income, producing a refund of the tax that had been paid on this amount. The tax on the taxpayer's 1966 net long-term capital gain, however, was unaffected by the 1968 loss, for reasons that will be explained *infra,* p. 15. The taxpayer therefore sought to carry $35,000 of its 1968 loss (*i.e.,* the original loss of $42,000, less the $7,000 that served to reduce its 1966 taxes) to 1967, a year in which it had about $114,000 of business income.

The court below, following the rule consistently adhered to by the Tax Court and (at that time) by all other Courts of Appeals, affirmed the district court. It agreed with the taxpayer that its 1968 loss could be carried to 1967, except to the extent ($7,000) that it was used to offset its 1966 business income, and that it was not further reduced by the 1966 long-term capital gains, since the tax paid on the capital gains was in no way diminished by the 1968 loss.

The government argues, to the contrary, that even though the 1968 loss did not diminish the tax on the 1966 long-term capital gains, it was nonetheless "absorbed" by such gains, so that there is no remaining loss to be carried to and deducted in 1967 and so that the rest of the 1968 loss was "used" in 1966 even though it resulted in no tax benefit.

These competing claims, as we will show, rest on alternative interpretations of ambiguous statutory language. After observing that "it is impossible to find any plain meaning in the statutory language that would dispose of the controversy" and that the taxpayer and government each offered "a plausible reading of [the statutory language] on its face," the court below rejected the government's construction and held that "the basic policy considerations underlying Sections 1201 [relating to the alternative tax on long-term capital gains] and 172 [providing for the carryover of net operating losses] decisively support the result reached by the district court." *United States v. Foster Lumber Co.*, 500 F.2d 1230, 1232 (8th Cir. 1974).

Before turning to the statutory language itself, we wish to illustrate for the Court the practical consequences of the competing claims of the parties, since it is only by examining these results that one can determine which interpretation will best serve the legislative objectives.

First, the relevant facts, related above, are set out in Table A.

TABLE A

Facts in *United States v. Foster Lumber Co.*
(Dollar amounts rounded off to nearest $1,000)

Year	Ordinary Income	Long-Term Capital Gain	Total Income
1966	$ 7,000	$167,000	$174,000
1967	114,000	115,000	229,000
1968	(42,000)	—0—	(42,000)
Total	$ 79,000	$282,000	$361,000

As indicated by the bottom line of Table A, the taxpayer's net economic gain during the period 1966-68 was $361,000—its net total income. This is the amount that will be taxed, after carrying the 1968 loss back to 1966 and 1967, if the decision below is upheld by this Court. Moreover, the appropriate rates are applied to this economic gain: the taxpayer's $79,000 of business income is taxed at the regular rate, and its $282,000 of capital gain is taxed at the capital gain rate. By contrast, the government asserts that the amount of income to be taxed is $396,000—$35,000 more than the taxpayer's net economic gain. The results of these competing interpretations of §172 are compared in Table B.

TABLE B

Amounts Taxed After Carryback of Net Operating Loss,
Under (A) Decision Below and (B) Government's Theory

	A. Decision Below			B. Government's Theory		
Year	Ordinary Income	Long-Term Capital Gain	Total	Ordinary Income	Long-Term Capital Gain	Total
1966	—0—	$167,000	$167,000	—0—	$167,000	$167,000
1967	79,000	115,000	194,000	114,000	115,000	229,000
1968	—0—	—0—	—0—	—0—	—0—	—0—
Total	$79,000	$282,000	$361,000	$114,000	$282,000	$396,000

If the bottom line of Table B is compared with the bottom line of Table A, it is readily apparent that the amounts actually subject to tax under the decision of the court below correspond precisely with the economic results of the taxpayer's operations; the government's theory, if accepted, would result in taxing $35,000 more income than was actually realized during the period. The disparity reflects the government's claim that the 1968 business loss was "absorbed" by the 1966

capital gain or, as the government sometimes puts the point, was fully "used" in 1966, even though it results in no tax benefit since neither the amount of capital gains subject to tax nor the tax payable thereon was reduced in any way by this alleged "absorption" or "use" of the 1968 loss. As we will point out (fn. 11, pp. 28-29, *infra*), the manner in which the government uses these terms, which do not appear in the Internal Revenue Code itself, serves to obscure rather than illuminate the issue to be decided by this Court.

Not only would the government's interpretation of §172, if accepted, tax more than the taxpayer's economic gain during the period 1966-68 in the circumstances that happen to be before the Court; it would also make the results depend on sheer accidents of timing. For, under the government's view, the so-called "absorption" without tax reduction takes place only if, in the carry years, the capital gain *precedes* the year or years of business profits; if the capital gain *coincides with* or is *subsequent to* business profits, the "absorption" will result in a tax reduction.

For example, if the taxpayer's 1966 and 1967 business income had been received in 1966 rather than split between two years, or if its 1966 and 1967 long-term capital gains had been received in 1967, it would clearly have been entitled to apply its 1968 business loss in full against its 1966-67 business income. As we shall show (*infra*, pp. 32-40), these are only some of the bizarre tax results which arise under the government's interpretation of §172. By contrast, the decision of the court below avoids these accidents of timing, for under its ruling, the result is the same whether the capital gain came first or later in the carryback years. Its decision achieves the legislative purpose of §172, which

was enacted to achieve something comparable to an average taxable income over a period of time. See Point I-C, *infra*, pp. 21-26.

We will show that the government's interpretation is not warranted by the statutory language, is contrary to the congressional policy in enacting §172, leads to absurd results in this case and in other situations, conflicts with the only Internal Revenue Service ruling in point, produces an insupportable result when combined with an important 1969 amendment to the Internal Revenue Code, and assumes a lack of expertise by the Tax Court which has consistently interpreted these complicated statutory provisions in the same manner as did the court below.

B. The Decision Below Is Consistent With the Controlling Statutory Provision, the Second Sentence of Section 172(b)(2).

1. We turn to the relevant provisions of the Internal Revenue Code of 1954, as amended. §172(c) defines "net operating loss" (hereafter NOL) as follows:

> "For purposes of this section, the term 'net operating loss' means (for any taxable year ending after December 31, 1953) the excess of the deductions allowed by this chapter over the gross income. Such excess shall be computed with the modifications specified in subsection (d)."

The modifications required by §172(d) will be examined at a later point (*infra*, pp. 48-50).

Net operating losses, as defined by §172(c), are carried from the loss year back to certain earlier years ("carrybacks") and forward to certain later years

("carryovers"), where they become available as net operating loss deductions, pursuant to the rules of §172(a) and (b). For convenience, we shall sometimes refer to the "carryback" years and the "carryover" years, in totality, as the "carry years."

An NOL is thus carried back to the 3 years immediately preceding the loss year and then forward to the 5 years immediately following that year in strict chronological order. The NOL must be used, to the extent possible, in the earliest year to which it is carried. Any balance is then carried to the next succeeding year, and so on, until the loss is exhausted by use or by expiration of the 9-year statutory cycle. When carried back to years preceding the loss year, an NOL ordinarily generates a refund of taxes already paid; when it is carried forward to years following the loss year, it is recorded on the tax return like any other deduction, and hence it reduces the tax to be paid when the return is filed.

Foster Lumber Co. was subject in 1966 to the so-called "alternative tax" under §1201(a), consisting of two components—a "partial tax" computed at the regular corporate tax rates under §11 on its net ordinary income, plus an amount equal to 25% of its net long-term capital gain. The carryback of the taxpayer's 1968 NOL to 1966 reduced its net ordinary income for that year from $7,000 to zero. Thus, its "partial tax," as recomputed under §1201(a), was also zero.

Since only $7,000 of the taxpayer's 1968 NOL was needed to wipe out its $7,000 of net ordinary income for 1966, it would seem at first blush that the $35,000 balance of the 1968 NOL (*i.e.*, $42,000 less $7,000) could be used to reduce the taxpayer's 1966 long-term

capital gain from $167,000 to $132,000 in computing the second component of the alternative tax under §1201(a)(2). But the Tax Court has already held to the contrary, namely, that the amount of capital gain subject to tax under the alternative computation is not to be reduced by the amount of any operating loss, regardless of whether the loss and the capital gain take place in the same year (*Weil v. Commissioner,* 23 T.C. 424 (1954), aff'd 229 F.2d 593 (6th Cir. 1956)) or the loss takes place in one year and the capital gain is in a carryback year (*Chartier Real Estate Co., Inc. v. Commissioner,* 52 T.C. 346 (1969), aff'd 428 F.2d 474 (1st Cir. 1970)). For purposes of our primary position, we accept this principle which, for convenience, will be referred to as the *Weil* principle.

2. The question of how much, if any, of the taxpayer's 1968 NOL was still available in 1967, after having reduced the 1966 business income of $7,000 to zero—the ultimate issue in the case—is governed by §172(b)(2) which provides, in pertinent part, as follows:

> ". . . the entire amount of the net operating loss for any taxable year (hereinafter in this section referred to as the 'loss year') shall be carried to the earliest of the taxable years to which (by reason of paragraph (1)) such loss may be carried. The portion of such loss which shall be carried to each of the other taxable years shall be the excess, if any, of the amount of such loss over the sum of the taxable income for each of the prior taxable years to which such loss may be carried."

Admittedly, so far as the precise problem presented here is concerned, the statutory language is not a

model of clarity. As the court below observed, either of two interpretations is plausible. The statute could mean, as the government argues, that so long as the taxable income (as defined by §63(a)) of any carry year is reduced,[2] the loss is, to that extent, "carried" to that year and is no longer available as a deduction in any other year, even though the "reduction" in taxable income in such earlier year is a pure abstraction and does not under the *Weil* principle reduce the tax burden of that year because it was a capital gain year in which the alternative method is to be used. But Congress could also have meant, as we contend and the court below held, that a loss has not been "carried" to an earlier year, and hence is still available as a deduction in a subsequent taxable year, to the extent it does not reduce the amount of taxable income which is subject to tax or diminish the tax burden of such earlier year—in short, if it does not produce a tax benefit.

This precise problem of statutory construction first arose in the United States Tax Court as the second issue in *Chartier Real Estate Co., Inc. v. Commissioner*, 52 T.C. 346 (1969) (where the *Weil* principle was also reaffirmed). For convenience, we shall sometimes refer to the rule there established as the *Chartier* principle. There, the government contended, as it does here, that even though the operating deficit of the loss year, and the NOL which it engendered, did not reduce the amount of capital gains subject to tax or diminish the tax on such capital gains in the carryback

[2]As a matter of statutory definition under §63(a), and under §172, the NOL does reduce "taxable income" in a carry year where there are capital gains taxed under the alternative tax. This reduction in taxable income appears only in an amended tax return or in an accountant's work sheet, but will not reduce the tax on the capital gains because of the *Weil* principle.

year, nonetheless, the net operating loss deduction was "absorbed" in the carry year in which there was a capital gain, since it reduced "taxable income" (and nothing else); hence, so it was contended, the loss could no longer be carried to the next profitable year despite the fact that it produced no tax benefit. This contention was rejected.

Since *Chartier* was the first time that this issue was considered, and since the Tax Court there also affirmed the *Weil* principle, we quote the reasoning of Judge Raum's opinion (at pp. 357-358):

> "We agree with petitioner's contention that the phrase 'to which such loss may be carried' modifies 'taxable income' as well as 'each of the prior taxable years.' We further hold that 'taxable income' in this context (as modified by the above phrase) means that taxable income to which the loss is actually applied in computing actual tax liability. . . . We think it is to exalt form over substance to contend that, since a 'regular' computation was made in order to determine whether the amount of tax resulting therefrom was greater than that produced by the 'alternative' method of computation, and since the net operating loss was deducted in full in the 'regular' method, the entire loss was therefore taken into account in the tax computation, even though the 'alternative' method, to which only $1,115.57 was applied, ultimately produced petitioner's actual tax liability."

And the First Circuit found the reasoning of Judge Raum to be so persuasive that it affirmed *per curiam*. Accepting the *Weil* principle that the tax on the capital gain was not reduced by the NOL, it also concluded,

with the Tax Court, that the unused NOL should be carried forward, saying (428 F.2d 474 at p. 475): "It does not seem inappropriate to place a floor at the alternate tax, leaving unused losses to their carryover utility" and that §172(b)(2) "means that taxable income to which the loss is actually applied in computing actual tax liability."

We contend, as was held by the Tax Court, by the court below, by all other district courts and two other Courts of Appeals,[3] that the preferable interpretation is that the phrase, repeated twice in §172(b)(2), "to which such loss may be carried," manifests a congressional intent that a loss would still be available as a deduction, and has not been "carried" to an earlier taxable year, when it has not diminished the taxable income subject to tax or reduced the tax burden of such earlier tax year. If Congress had intended that a mere abstract reduction in the statutory concept of taxable income for one year, as that term is defined by §63(a), not accompanied by any reduction in the tax burden of that year, was sufficient to deprive the taxpayer of the use of the loss to reduce its tax burden in another

[3]The statutory interpretation decided by the Tax Court, and affirmed by the First Circuit, in *Chartier* has since been followed by the Ninth Circuit in two cases, by the Eighth Circuit in the *Foster Lumber* case, by all District Courts which have passed on the issue, and by the Tax Court in subsequent decisions: *Olympic Foundry Co. v. United States,* 493 F.2d 1247 (9th Cir. 1974); *Data Products Corp. v. United States,* aff'd. December 27, 1974 by the Ninth Circuit in an unpublished opinion, No. 74-3341 (pending in this Court on a petition for certiorari filed by the United States (No. 74-996)); *Naegele v. United States,* decided August 6, 1973 (D. Minn.), pending on appeal in the Eighth Circuit No. 73-1921; *Continental Equities Inc. v. Commissioner,* 33 T.C.M. 812 (1974), pending on appeal in the Fifth Circuit; *Mutual Assurance Society of Virginia Corp. v. Commissioner,* 32 T.C.M. 839 (1973), reversed, 505 F.2d 128 (4th Cir. 1975). *Olympic, Data* and *Foster* involved affirmances of three different United States District Courts.

year, it would have used explicit statutory language to say so.

The statute, as construed by the court below and by all the other courts which have followed *Chartier,* simply means that an NOL has been "carried" to a year when it reduces the taxable income on which the ultimate tax is calculated and results in lowering the tax. Conversely, if the NOL merely reduces taxable income, but does not reduce the taxable income on which the tax is computed (as is true under *Weil* where there are capital gains subject to the alternative tax), the loss has not been "carried" to the taxable income of that year.

3. The government's contention, made at considerable length (Br. pp. 17-28) to the effect that "taxable income" in §172(b)(2) means taxable income as defined in §63(a), including capital gains, is a proposition with which we agree. But since none of the courts, including the court below, disagreed, the government's lengthy discussion should not succeed in raising a false issue and in distracting attention from the real question whether an NOL has been "carried" to the taxable income of a particular year if it does not diminish the taxable income of that year on which the tax is computed. Contrary to what the government claims, the quotation from *Chartier, supra,* p. 17, shows quite plainly that the Tax Court did not find that the bare words "taxable income" in §172(b)(2) had a different meaning than they have in §63(a); rather, it was the "carried" language of §172(b)(2) that proved to that court the congressional intent to have the statute operate in, what we contend, is the appropriate manner. Nor did any of the other courts which have followed

Chartier interpret "taxable income" in §172(b)(2) differently than its §63(a) definition.

4. Still staying with the statutory language and before we turn to other aids to construing the statute, we should take note of the government's assertion that the Tax Court's construction of §172(b)(2) is contrary to the "usage of the Code," in that losses are "deducted" from, not "carried" to, taxable income, and that the term "carried" as used in §172(b)(2) has (Br. p. 26): "the temporal connotation of a transfer of a loss from the year in which it occurred, and would normally be taken into account, to another year." This argument is offered to rebut the Tax Court's view that the phrase "to which such loss may be carried" in the second sentence of §172(b)(2) modifies "taxable income" as well as "prior taxable years." But "carried' is often used in a nontemporal sense. For example:

> "2. To transfer from one place (as a country, book, or column) to another: as . . . to *carry* a number in adding." (Webster's New International Dictionary of the English Language, 2d ed., Definition of "carry.")

Every schoolchild learns to record the results of adding 5 and 7, for example, by reciting "5 and 7 are 12; put down the two; and *carry* the one." To take an example that is closer to home, the final sentence of §1212(a)(1), dealing with the carryback of net capital losses, clearly uses the terms "cannot be carried back in full" and "the amount of such loss which can be carried back" in a numerical sense, referring to amounts that either can, or cannot, be deducted when carried to the earlier year. This provision—the Code's closest statutory analogy to §172—rebuts the government's assertion that "carry" is used in the Code only in a "temporal" sense and that it does not embrace the concept of a deduction.[4]

C. The Decision Below Is Consistent With the Basic Policy of Section 172 to "Average" the Tax Burden by Reducing the Harsh Consequences of the Annual Accounting Period.

1. As is obvious, the fundamental congressional policy for providing a net operating loss deduction comes from the recognition that, in certain circumstances, an annual accounting system for measuring the ability to pay an income tax works too harshly and requires modification.[5] The purpose of the net operating loss provisions has been to arrive at a fair measure of the tax burden by measuring profits during the nine year statutory time span, rather than on a year by year basis, and to achieve some parity between the business whose earnings (measured year by year) are volatile and those whose profits are earned more evenly. As this Court stated in *Libson Shops, Inc. v. Koehler,* 353 U.S. 382, 386 (1957):

> "These provisions were enacted to ameliorate the unduly drastic consequences of taxing income strictly on an annual basis. They were designed to permit a taxpayer to setoff its lean years against its lush years, and to strike something like an average taxable income computed over a period longer than one year."

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[4]See also Rev. Rul. 66-91, 1966-1 C.B. 54, which uses "carry" in a nontemporal sense, as pointed out *infra,* pp. 42-43.

[5]There are other instances where Congress has mitigated the harshness which would result from a rigid adherence to an annual accounting period system. They include: the investment credit carryover (Section 46(b)); the charitable contribution

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In the words of *Reo Motors, Inc. v. Commissioner,* 338 U.S. 442, 449 (1950), the purpose was ". . . to equalize tax burdens." And the court below also correctly described the congressional policy when it said (500 F.2d at 1232):

> "The basic purpose behind the net operating loss carryback provisions of section 172 is to ameliorate the harsh tax consequences that can result from the necessity of accounting for certain exceptional economic events within the confines of an arbitrary accounting period."

The foregoing summary by the courts of the overall congressional purpose finds support, not only in what the statute does, but in what Congress has repeatedly explained as its policy objective. Thus, after being absent during the worst of the depression years when there was an urgent need for revenue, provisions for the net operating loss deduction (which had originated in 1918) were reintroduced in the Revenue Act of 1939[6] (Act of June 29, 1939, c. 247, §211, 53 Stat. 862) (§§23(s) and 122 of the Internal Revenue Code of 1939, as amended); the fundamental policy was well explained by the House Ways and Means Committee in connection with the 1939 Act as follows (H. R. Rep.

deduction carryover (Section 170(d)); the taxation of lump sum distributions from qualified plans (Section 402(e)); the installment method of reporting gain (Section 453); deferral of income from pre-paid subscription income and pre-paid membership dues (Sections 455 and 456); consent dividends (Section 565); foreign tax credit carryover (Section 904(d) and (e)); capital loss carryover (Section 1212); income averaging (Section 1301); and computation of tax when income, received under claim of right, is later repaid (Sections 1341 and 1342).

[6]The 1938 Act had granted a limited credit for certain purposes so that the results of a loss year could be reflected in the following year.

No. 855, 76th Cong., 1st Sess. (1939-2 C.B. pp. 504, 510-511)):

> "2. Net loss carry-over.—The bill, together with committee amendments, permits taxpayers to carry over net operating business losses for a period of two years. Prior to the Revenue Act of 1932, such 2-year carry-over was allowed. No net loss has ever been allowed for a greater period than two years. In the Revenue Act of 1932, the 2-year net loss carry-over was reduced to one year and in the National Industrial Recovery Act the net loss carry-over was entirely eliminated. As a result of the elimination of this carry-over, a business with alternating profit and loss is required to pay higher taxes over a period of years than a business with stable profits, although the average income of the two firms is equal. New enterprises and the capital goods industries are especially subject to wide fluctuations in earnings. It is, therefore, believed that the allowance of a net operating business loss carry-over will greatly aid business and stimulate new enterprises. . . . An example will show the necessity for such a provision.
>
> Suppose a corporation, over the 3-year period 1939-41, shows the following:
>
> Net operating loss for 1939 .....$2,000,000
> Normal-tax net income for 1940 1,000,000
> Normal-tax net income for 1941 1,000,000
>
> Looking at this 3-year period, it will be seen that the corporation has not made any profit. However, assuming a flat rate of 18 per cent, it would be required to pay a tax of $360,000 if

there were no provision for a net loss carry-over. Under the bill, a corporation in such a case would not be required to pay an income tax."

It will not be overlooked that Congress was concerned with the *taxes* which a business would pay, an objective emphasized in *Libson Shops* and *Reo Motors, supra,* not just a definition of net income which has no effect on the tax cost. And it was also concerned with the economic effect on competitors, desiring to place them in a comparable position so far as *ultimate taxes* paid are concerned, not merely in a comparable definitional status.

The beneficent purposes of the net operating loss deduction were further explained by an influential 1947 report, prepared jointly by the staffs of the Treasury Department and the Joint Committee on Internal Revenue Taxation, from which we quote a pertinent portion:

"A. EQUITY CONSIDERATIONS

In the absence of the loss offsets, the business entity whose net income becomes negative in some periods is not permitted to deduct all the expenses of earning income. To this extent, the tax on net income becomes a tax on capital. The owners of such a firm are discriminated against, because higher taxes are levied on their net income than on the income of owners of businesses with stable income.

B. ECONOMIC CONSIDERATIONS

1. *To remove impediments to risk-taking*

Without loss offsets, investments in assets with less risk of loss are favored over those in which

the risk may be greater. Thus, the absence of loss offsets will reduce the relative investment in risky assets and ventures. Investment in such assets and ventures may be particularly desirable in the economy. Ventures may be risky because they are new firms challenging established ones or introducing new products. If successful, they may bring reduced prices in the industry they enter, or may create employment in an entirely new industry. They may be faced with a period of hard sledding and losses in their early years. If losses in this period cannot be offset against income of future periods, the prospective return from the investment is reduced relative to the return connected with a safer haven for their funds.

2. *To increase the countercyclical effect of taxes*

Absence of loss offsets may also contribute to cyclical instability. In years of losses, expenditures will be held to a minimum. The making of these expenditures may be unprofitable when the firm bears their full cost but must pay a tax on the additional income they would bring in. Yet they might profitably be made if the cost of the expenditure could reduce taxes through loss offsets."[7]

Plainly, the government's "absorption without tax benefit" approach flies in the teeth of these policy objectives of Congress.

2. The problem presented in this case of the relationship between the "averaging" policy of Congress and the taxation of capital gains could not have

[7]Business-Loss Offsets, Hearings on Proposed Revisions of the Internal Revenue Code, Part 5, p. 3784 (1947), in House Committee on Ways and Means, 80th Cong., 1st Sess.

arisen until 1942, when corporate capital gains first became subject to a flat rate of tax. Before 1942, an operating loss of a corporation would always have reduced the tax on both business income and capital gains.

What is important is that, when the alternative tax on long-term capital gains for corporations was instituted by the Revenue Act of 1942, c. 619, §150, 56 Stat. 798, Congress simultaneously amended the net operating loss provisions. We deem it significant that, despite the extensive discussion of the changes made in both parts of the statute, *there is not one word* in the committee discussions to indicate that a carryback would then become meaningless from the viewpoint of the taxes actually imposed on a corporation (and meaningful only in computing revised taxable income on a work sheet) if the carryback was to a year in which the new alternative tax was required to be used, so that the carryback would reduce how net income was calculated, but not the ultimate tax to be paid.

Since Congress was concerned with alleviating the tax burden which would otherwise be arbitrarily imposed by a slavish adherence to a pure annual accounting system, and since this goal could not be achieved merely by reducing what is defined as net income, without diminishing the tax cost, we believe that Congress, had it intended what is being urged by the government, would have explained why it had chosen such a legislative approach or would have made it clear that it tempered its objective, if capital gains were involved in a

carryback or carryover year. Its failure to speak is, we submit, more consonant with the conclusion that it never thought that it was acting in such a non-meaningful manner.[8]

The subsequent legislative history is also eloquent. Thus, while the Revenue Act of 1950, c. 994, 64 Stat. 906, and the Revenue Act of 1951, c. 521, 65 Stat. 452, each made changes both in the net operating loss and the capital gain provisions, and the Technical Changes Act of 1953, c. 512, 67 Stat. 615, again amended the net operating loss provisions, there is not one word of explanation in connection with these three enactments to lend support to the strange interpretation now being urged by the government.[9]

The legislative history is persuasive in still other respects. By the enactment of the Internal Revenue Code of 1954, Congress took a giant step in revising some of the major provisions of the entire tax structure; it also attempted to clarify the language of the statute. The Committee Reports accompanying the 1954 Code contain an extensive explanation of what *substantive* changes Congress was making in the taxing statute.

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[8]See H. R. Rep. No. 2333, 77th Cong., 1st Sess. (1942-2 C.B. 372, 399, 443-444); S. Rep. No. 1631, 77th Cong., 2nd Sess. (1942-2 C.B. 504, 556, 596-597).

[9]See Revenue Act of 1950—H. R. Rep. No. 2319, 81st Cong., 2nd Sess. (1950-2 C. B. 380, 424-425, 445-449); S. Rep. No. 2375, 81st Cong., 1st Sess. (1950-2 C.B. 483, 515-517, 523-524, 543-546).

Revenue Act of 1951—H. R. Rep. No. 586, 82nd Cong., 1st Sess. (1951-2 C.B. 357, 440-442); S. Rep. No. 781, 82nd Cong., 1st Sess. (1951-2 C.B. 458, 481, 498-499, 572-574). See also the

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The 1954 Code made some changes of substance in the net operating loss provisions, which were discussed in the Committee Reports. And, the clarifying language "to which such loss may be carried" had its origin in the 1954 Code.[10] Significantly in using this language, Congress did not indicate that an NOL would achieve no tax reduction where capital gains subject to the alternative computation were involved in a carry year. Moreover, such words as were used tend to indicate it had the opposite thought in mind. For example, in lengthening the carryback period from one to two years, it explained that this not only resulted in an eight year period "for absorbing a loss" but, by increasing the carryback period (and the opportunity for an immediate refund) the statute would "increase the liquid funds for a business experiencing economic reversals".[11] If the government's views are correct, and

discussion of the Joint Committee Staff, accompanying the Revenue Act of 1951 (see 1951-2 C.B. 287, 314-315).

Technical Changes Act of 1953—H. R. Rep. No. 894, 83rd Cong., 1st Sess. (1953-2 C.B. 508, 519-520); S. Rep. No. 685, 83rd Cong., 1st Sess. (1953-2 C.B. 526, 529-530).

[10]See H. R. Rep. No. 1337, 83rd Cong., 2nd Sess. 27 (1954); S. Rep. No. 1622, 83rd Cong., 2nd Sess. 31 (1954), H. R. Conf. Rep. No. 2543, 83rd Cong., 2nd Sess. 30 (1954).

[11]Several significant observations can be made regarding Treasury Regulations 111, §29.122-1, as amended by T.D. 5963, December 16, 1952, issued under the Internal Revenue Code of 1939, as amended. It provided that: "The amount of the net operating loss which may be carried back or carried over to any taxable year is the net operating loss to the extent it was not absorbed by the net income for the other taxable years, preceding such taxable year, to which it was carried back or carried over."

First, the word "absorbed" is not a term appearing in either the 1939 or 1954 Code. As used in the Regulations, however, it conveys the impression that an NOL has not been "absorbed" in another year if it does not reduce the income of such year subject to tax. Secondly, like the current Regulations, which also sometimes uses the word "absorbed," no example is given where

if there were prior capital gains, there could be no increase in liquid funds.

Finally, despite changes made by the Technical Amendments Act of 1958, Public Law 85-866, 72 Stat. 1606, in the net operating loss deduction, and by the Tax Reform Act of 1969, Public Law 91-172, 83 Stat. 487, which dealt both with the capital gains provisions as well as the net operating loss provisions, the Committee Reports do not contain any discussion of this point.

It should be emphasized that the Tax Reform Act of 1969 was enacted after *Chartier* was decided by the Tax Court. If Congress had disagreed with its result, it might be expected to have expressed its disapproval, particularly since the legislation there dealt not only with the net operating loss deduction but also with capital gains and capital losses.[12] Indeed, as we shall

capital gains are subject to the alternative tax, and where (on the government's present theory) the NOL would be "absorbed" even though it produced no reduction in tax. Congress would certainly have been led by these provisions of the Regulations to believe that the statute was being administered in such a way that, within the statutory period, an NOL would be reduced only if it had reduced the taxpayer's actual tax liability. Thirdly, the "carried" language of §172(b)(2) of the 1954 Code may have found its origin in the prior Regulations. But, no matter what its source, it helps to clarify the point that there could be no "absorption" without tax reduction.

It will be noted that the government's brief also uses the term "absorbed" (it also employs the term "used" interchangeably), but in exactly the opposite sense—namely, to mean a reduction in "taxable income" but with no accompanying reduction in tax. As our entire brief demonstrates, the government can point to nothing supporting the strained meaning which it puts on these words and, as used by it in this opposite manner, the words confuse rather than clarify the ultimate issue.

[12]See: Technical Amendments Act of 1958—H. R. Rep. No. 775, 85th Cong., 1st Sess. (1958-3 C.B. 811, 822); S. Rep. No. 1983, 85th Cong., 2nd Sess. (1958-3 C.B. 922, 944-945,

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also discuss under point I-E, *infra*, pp. 38-41, the carryback of capital loss provisions of the 1969 Act are actually incompatible with the interpretation of §172 urged by the government. Consequently, the failure of Congress to reject *Chartier* is further indication of why the court below was correct.

While the legislative history does not, on its face, provide an express answer to the issue here, the absence of any discussion during the many opportunities which Congress had is significant. The silence of Congress, when one would have expected an explanation of a result which would only affect abstract computations on a work sheet, but not the ultimate tax cost, is persuasive that no purely mechanistic result was contemplated.

3. In the light of these consequences of the government's theory, it is not surprising—though it remains noteworthy—that the government's brief makes no serious attempt to reconcile its interpretation of §172(b)(2) with the announced objectives of the legislation. Its assiduous silence is broken only once, by a reference (Br. pp. 29-30) to a 1939 report of the House Committee on Ways and Means, which is described as embodying "the congressional understanding that absent a pre-existing carryback or carryover, no net operating loss deduction can be carried from a year in which the taxpayer does not suffer a loss." According to the government, this "congressional understanding" precludes carrying any part of the taxpayer's 1968

1052-1053); H. R. Conf. Rep. No. 2632, 85th Cong., 2nd Sess. (1958-3 C.B. 1188, 1207).

Tax Reform Act of 1969—H. R. Rep. No. 91-413, 91st Cong., 1st Sess. (1969-3 C.B. 200, 284-285, 290-293, 402-404); S. Rep. No. 91-552, 91st Cong., 1st Sess. (1969-3 C.B. 423, 544, 546-547); H. R. Conf. Rep. No. 91-782, 91st Cong., 1st Sess. (1969-3 C.B. 644, 667-668).

NOL from 1966 to 1967 because "it did not suffer a loss for 1966."

The congressional statement, which is merely cited, but not quoted by the government, in support of this argument, actually reads as follows:

> "The net operating loss deduction is the net operating loss carryover reduced by certain adjustments intended to prevent net losses from being used as a deduction by the taxpayer where he is not suffering any economic loss by reason of the fact that his income contains nontaxable items (as in the case of percentage depletion, exempt interest on State and local bonds, and, with respect to corporations, intercorporate dividends, and interest on partially exempt federal obligations)."[13]

The point to be made about this statement is that it describes, not the provisions of the 1954 Code, but a statutory scheme that was abandoned in 1954;[14] for the years before the Court, an NOL could be carried to and used in a year in which the taxpayer's income contained any of the items mentioned in the quoted statement. Secondly, even if the statement had continued validity, rather than describing obsolete history, it is concerned entirely with the taxpayer who "is not suffering any economic loss *by reason of the fact that his income contains nontaxable items.*" (Emphasis added.)

[13]Detailed Discussion of Certain Technical Provisions of the Revenue Bill of 1939. H. R. Rep. No. 855, 76th Cong., 1st Sess. (1939-2 C.B. 504, 517).

[14]See, for example, S. Rep. No. 1983. 85th Cong., 2nd Sess., pp. 944-945, which recognized that the 1954 Code had departed from the previous economic income concept, so that taxpayers with losses would have the same deductions as taxpayers "with more stable incomes" and that the 1954 Code provisions were more "generous" than before.

Because the alternative tax applied to the taxpayer before the Court, its 1966 long-term capital gains qualified for a reduced rate of tax, but the full amount of the gains was subject to tax; the gains were not in any sense "nontaxable items," and hence would not have been within the ambit of the cited committee report even in the years to which it refers.

If the government's research has discovered firmer support in the legislative history for its interpretation of §172(b)(2), and not merely this flimsy reed, it is not mentioned in the government's brief. In our view, the court below rightly concluded that the basic policy considerations leading Congress to enact §172, which we have summarized above, "decisively" support the interpretation of §172(b)(2) adopted by the court below and, earlier, by the Tax Court in the *Chartier* case.

D. Under the Government's Statutory Interpretation—Which Results in a Tax Deduction Without a Tax Benefit—Accidents of Timing Are Crucial, Although Section 172 Was Enacted to Reduce the Importance of Timing.

1. As shown by Table B, *supra*, p. 11, the government's interpretation of the second sentence of §172(b)(2), if accepted, would tax the taxpayer before the Court on $35,000 more than its economic gain. While this is objectionable in itself and inconsistent with a remedial statute "designed to permit a taxpayer to set off its lean years against its lush years" (*Libson Shops, supra*, p. 21), it is made even more offensive by the capricious nature of the tax burden imposed on the taxpayer. This is so because the government's construction, which results in "absorption" without a reduction in tax, only comes into play if the capital gain in the carry years *precedes* a profit year; if the capital gain

is *concurrent with* or *follows* a profit year, the "absorption" does result in a reduction in tax. Thus, under the government's theory, taxpayers whose circumstances are identical with the taxpayer at bar, save for additional accidents of timing, would either escape its fate or be even worse off.

Thus, a competitor who happened to incur the same 1966 and 1967 business transactions as the taxpayer but in the reverse annual order (but with no change in the time when capital gains were realized), would be able to use its $42,000 of 1968 NOL in full against its business income, and thus would be taxed on $35,000 less than the government seeks to tax to the taxpayer before the Court. This phenomenon, which can hardly be disputed by the government, is illustrated by Table C.

TABLE C

Amounts Taxed if 1966 and 1967 Business Transactions Were Reversed

	— Before Carryback —			—After Carryback —		
Year	Ordinary Income	Long-Term Capital Gain	Total	Ordinary Income	Long-Term Capital Gain	Total
1966	$114,000	$167,000	$281,000	$72,000	$167,000	$239,000
1967	7,000	115,000	122,000	7,000	115,000	122,000
1968	(42,000)	— 0 —	(42,000)	— 0 —	— 0 —	— 0 —
Total	$ 79,000	$282,000	$361,000	$79,000	$282,000	$361,000

A second competitor, who happened to receive in 1966 the business income that the taxpayer before the Court realized in the period 1966-1967, but whose capital gain transactions were also identical with the taxpayer, would also be able to take full advantage of its 1968 NOL. This set of circumstances is illustrated by Table D.

TABLE D

Amounts Taxed if 1966 and 1967 Business Income Were Received in 1966

	— Before Carryback —			— After Carryback —		
Year	Ordinary Income	Long-Term Capital Gain	Total	Ordinary Income	Long-Term Capital Gain	Total
1966	$121,000	$167,000	$288,000	$79,000	$167,000	$246,000
1967	— 0 —	115,000	115,000	— 0 —	115,000	115,000
1968	(42,000)	— 0 —	(42,000)	— 0 —	— 0 —	— 0 —
Total	$ 79,000	$282,000	$361,000	$79,000	$282,000	$361,000

A third competitor who happened to combine into a single year (either 1966 or 1967) both the business income and capital gains that were divided between 1966 and 1967 by the taxpayer before the Court, would also get full advantage of the 1968 NOL. This is shown by Table E.

TABLE E

Amounts Taxed if 1966 and 1967 Were Combined in 1966[15]

	— Before Carryback —			— After Carryback —		
Year	Ordinary Income	Long-Term Capital Gain	Total	Ordinary Income	Long-Term Capital Gain	Total
1966	$121,000	$282,000	$403,000	$79,000	$282,000	$361,000
1967	— 0 —	— 0 —	— 0 —	— 0 —	— 0 —	— 0 —
1968	(42,000)	— 0 —	(42,000)	— 0 —	— 0 —	— 0 —
Total	$ 79,000	$282,000	$361,000	$79,000	$282,000	$361,000

Still another bizarre result of the happenstance of timing is illustrated by Table F, which assumes a competitor with the same capital gains as were realized by Foster Lumber Co., but which realized in 1967 the business income that Foster Lumber Co. realized in

[15]Dollar totals would be unchanged if 1966 and 1967 transactions occurred in 1967, rather than in 1966.

1966 and 1967. This hypothetical competitor would —under the government's theory—derive no tax benefit from its 1968 NOL (not even the $7,000 which benefited Foster Lumber Co.). Hence, it would be even worse off than the taxpayer before the Court, being overtaxed on income in the amount of $42,000.

TABLE F

Amounts Taxed Under Government's Theory if 1966 and 1967 Business Income Were Received in 1967

	— Before Carryback —			— After Carryback —		
Year	Ordinary Income	Long-Term Capital Gain	Total	Ordinary Income	Long-Term Capital Gain	Total
1966	— 0 —	$167,000	$167,000	— 0 —	$167,000	$167,000
1967	$121,000	115,000	236,000	$121,000	115,000	236,000
1968	(42,000)	— 0 —	(42,000)	— 0 —	— 0 —	— 0 —
Total	$ 79,000	$282,000	$361,000	$121,000	$282,000	$403,000

Finally, we ask the Court's indulgence while we offer one more computation, to illustrate what might be termed the normal taxpayer, which realizes its business income in equal installments over a 3-year period. Since §172 is designed to put taxpayers with fluctuating income on a plane of relative equality with those having a stable source of income, this "normal" taxpayer is an appropriate standard against which to measure the two competing interpretations of §172(b)(2) that are before the Court.

TABLE G

Business Income Realized in Equal Annual Installments

Year	Ordinary Income	Long-Term Capital Gain	Total
1966	$26,333	$167,000	$193,333
1967	26,333	115,000	141,333
1968	26,334	— 0 —	26,334
Total	$79,000	$282,000	$361,000

The tax results for this "normal" taxpayer conform to the results achieved for all of the taxpayers illustrated by Tables A through F, when the net operating loss deduction is computed in accordance with the decision below. If the government's interpretation of §172 (b)(2) is accepted, however, the caprice of timing will determine which taxpayers qualify for the "normal" pattern and which ones, instead, are taxed on more than their economic gain.

2. Because it is so dependent on accidents of timing, the government's construction of §172(b)(2) has a freakish effect whenever Congress increases the carryback period for net operating losses, as it has done on several occasions. The problem can be illustrated by reference to Table A. If the statutory carryback period had been limited to one year (as was the case, for example, from 1951 to 1954), the taxpayer before the Court would have been able to use its 1968 NOL in full against its 1967 business income. The 1968 NOL was useless (under the government's theory) to the extent of $35,000 only because the first year to which it had to be carried was 1966 rather than 1967. Thus, an increase in the carryback period has the perverse effect of worsening the taxpayer's position whenever an alternative tax year is added to the carryback period. This undermines the legislative objective, as set out by the House Committee on Ways and Means when it recommended a lengthened carryback period in 1954:

> "The longer period for averaging will improve the equity of the tax system as between businesses with fluctuating income and those with comparatively stable incomes, and will be particularly helpful to the riskier types of enterprises which encounter marked variations in profitability. The additional year for the carryback also increases the liquid funds available for a business experiencing economic reverses."[16]

Unlike the government's construction of §172(b)(2) the decision of the court below does not have the untoward effect of penalizing taxpayers when there is a statutory increase in the carryback period, so that the NOL has to be carried back to a tax year in which there was capital gain subject to the alternative tax.

Moreover, the government's construction of §172 (b)(2), by attaching such great significance to the order in which ordinary business income and capital gains are realized, would encourage canny taxpayers to adopt countermeasures as a defensive strategy.[17] For example, by postponing the recognition of capital gains, they would be able to increase the possibility of applying an NOL to business income or, conversely, by postponing business expenditures they could increase the likelihood of using business losses against business income.

Both of these tactics would fly in the face of congressional policies to the contrary. A major reason for the reduced rate on capital gain is the congressional desire not to inhibit the disposition of capital assets. Moreover, as we have pointed out (*supra*, pp. 24-25), one of the congressional reasons for enacting the net operating

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[16]H. R. Rep. No. 1337, 83rd Cong., 2nd Sess. 27 (1954).

[17]This is not idle speculation. A leading tax publication has already pointed out the possibility of tax-motivated maneuvers of this type, which would become advisable if this Court adopts the government's theory. Tax Management Memorandum, June 9, 1975.

loss carryback was to encourage taxpayers to make business expenditures when justified by business condition, rather than to postpone such expenditures for tax reasons. Under the decision below, there is no premium on such artificialities.

E. The Decision Below Is Consistent, and the Government's Theory Is Inconsistent, With Section 1212(a), Enacted in 1969 to Permit Corporations to Carry Capital Losses Back for Three Years.

1. When Congress enacted the alternative method of taxing corporations on their long-term gains in 1942, it simultaneously provided that corporate capital losses could be deducted only to the extent of capital gains. See §1211(a). For this reason, corporate capital losses cannot create net operating losses. Until 1969, corporations could carry their unused capital losses forward but not back to years preceding the year of the loss. In 1969, however, Congress for the first time authorized corporations (but not individuals) to carry their capital losses back to the 3 years immediately preceding the loss year. See §1212(a)(1)(A). Whether carried back under this new provision or forward under the older provision, now §1212(a)(1)(B), the loss is treated as a short-term capital loss in the year to which it is carried, and hence it remains subject to §1211(a) and can be used only against capital gains. Since corporate capital gains were subject to a ceiling rate of 25% in the years under consideration (the rate has since been increased) the legislative scheme embodied in §1211(a) and §1212(a)(1) imposes parallel treatment on capital losses by permitting them to be used only against capital gains, and not against business income that would otherwise be taxed at the regular rate.

But if the government's contention in the case at bar were accepted, the 1969 legislation would have had a startling side-effect so that, where there are net operating loss carrybacks, capital losses could be used against business income. This can be illustrated by extending Table A to assume that the taxpayer realized a net capital loss of $167,000 in 1969.

TABLE H

Table A Extended to Include
1969 Capital Loss of $167,000

Year	Ordinary Income	Long-Term Capital Gain	Taxable Income
1966	$ 7,000	$167,000	$174,000
1967	114,000	115,000	229,000
1968	(42,000)	— 0 —	(42,000)
1969	— 0 —	(167,000)	(167,000)
Total	$ 79,000	$115,000	$194,000

As of the end of 1968, according to the theory advanced by the government, the taxpayer's 1968 NOL was already fully exhausted. But if the taxpayer then incurred the 1969 capital loss of $167,000 that is hypothesized in Table H, it would be permitted by §1212(a)(1)(A) to carry the loss back to 1966,[18] where it would wipe out the capital gain of $167,000.

The startling side effect is that, with the elimination of the 1966 capital gain by carryback of the 1969 capital loss, even the government could no longer contend that the 1968 business loss was absorbed by the same 1966 capital gain. As a result, the 1968 busi-

[18]In point of fact, the 1969 legislation was applicable only to capital losses incurred after Dec. 31, 1969, but the principle illustrated above is correct; and it could be made technically applicable by changing the taxable years in Table H from 1966-69 to 1967-70.

ness loss which, under the government's theory, had been already fully "consumed" before 1969, would now turn out to be revived by the 1969 capital loss. The net effect of the 1969 capital loss, therefore, would not only be an elimination of the tax on the 1966 capital gain (as Congress intended); it would also produce a refund of tax on 1967 business income (which was never the intent of Congress). It would do so by, in effect, creating a net operating loss carryback despite §1212(a)(1)(A)(ii), which expressly provides that a capital loss carryback shall not "increase or produce a net operating loss . . . for the taxable year to which it is being carried."

That this bizarre result would follow from the government's approach to §172 is further evidence that its construction falls wide of the congressional intent. The *Chartier* interpretation, on the contrary, leads to the precise results always contemplated by Congress; ordinary business losses are applied against business income of other years; capital losses offset capital gains of other years.

2. The 1969 legislation is instructive in another respect. The second sentence of §1212(a)(1) provides that a corporation's net capital loss shall be carried back to the earliest year to which it may be carried and then prescribes, in language reminiscent of the second sentence of §172(b)(2), the amount of the loss that may be carried to subsequent years. By itself, this sentence suffers from the same ambiguity that afflicts the statutory language before this Court. But the final sentence of §1212(a)(1) resolves the ambiguity in substantially the same way that the court below resolved the ambiguity in §172(b)(2), viz., the loss is reduced only to the extent that it served to reduce gains

subject to tax and hence the taxpayer's tax liability for the earlier year, and the balance is carried forward to the next year.

This explicit language was inserted in §1212(a)(1) by the conference committee, whose report was filed more than six months after the Tax Court's decision in *Chartier*. Not only did the draftsmen of §1212(a)(1) reach the same result as *Chartier* in resolving the same kind of problem, but they simultaneously refrained from amending §172(b)(2) to overrule *Chartier*, even though another part of §172 was amended by the Tax Reform Act of 1969. See §431(b), Public Law 91-172, 83 Stat. 487. These circumstances, as we have stated, pp. 29-30, *supra*, strongly imply legislative satisfaction with the *Chartier* interpretation of §172(b)(2); at a minimum, at a time when the issue was almost certainly fresh and the Internal Revenue Code of 1954 was being extensively revised, it is significant that Congress failed to indicate any disapproval of *Chartier*, either by revising §172(b)(2) or by adopting a different solution to a comparable problem in the computation of net capital loss carrybacks.

F. The Administrative Practice Supports the Decision Below and Is Inconsistent With the Theory Urged Here by the Government.

1. In a controversy of this type, involving a narrow issue of statutory construction that has been litigated only recently (despite the many prior years when the issue must have arisen in tax returns), the government usually invokes long-standing administrative practice in support of its interpretation. There is no claim of such support here, and with good reason. The only insight into administrative practice is to be found in Rev. Rul.

66-91, 1966-1 C.B. 54, which is inconsistent with the government's current reading of §172(b)(2).

That ruling involved a corporation with "taxable income" in 1961, when it was a member of a group filing a consolidated net operating loss. On January 1, 1962, the taxpayer severed its affiliation with its parent and thereafter filed separate income tax returns. Its 1962 and 1963 returns reported taxable income; in 1964, the taxpayer sustained a net operating loss, which it sought to carry back to 1962 and 1963, rather than to 1961. The Internal Revenue Service ruled that the taxpayer was not required to carry its 1964 loss back to 1961 (where it would have been reduced by the taxpayer's taxable income) "since there was no consolidated taxable income for 1961."

Under the reasoning urged here by the government, however, the taxpayer's 1964 net operating loss would have been "consumed," "used," or "absorbed" by its 1961 "taxable income" to the extent thereof. On the other hand, the ruling supports our position that an NOL is to be reduced, under §172(b)(2), only by the "taxable income . . . to which such loss may be carried." The corporation in the ruling had "taxable income" for 1961, but in the absence of any consolidated taxable income for 1961, there was no 1961 amount to which the 1964 loss could be "carried."

The government's brief (p. 26) as we have previously noted, asserts that the term "carried" has only a "temporal connotation" so that an NOL cannot be "carried" to taxable income. But in Rev. Rul. 66-91, the 1964 NOL could readily be "carried," in the temporal sense, to 1961; the basis of the ruling was that there was no income in 1961 to which the loss could

be "carried." Rev. Rul. 66-91 clearly implies that if the group had reported consolidated net income for 1961, the 1964 NOL would have to be "carried" to this amount.[19]

Thus, the only relevant insight into administrative practice supports the construction of §172(b)(2) adopted by the court below, and is correspondingly inconsistent with the position now being urged by the government.

2. Normally, too, the government is able to point to long-standing Treasury Regulations to support its position. As we shall see, this is not the situation here. Indeed, it is significant that the Regulations seem to have carefully avoided speaking to this problem, thus avoiding a declaration which could have been known to Congress and approved by it, prior to the adoption of its present litigating position by the government.

While the government cites (p. 19) several provisions of the Treasury Regulations as in "accord" with its interpretation of the statutory language of §172(b)(2), an examination of their provisions shows this not to be the case. The first of these references, Treas.

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[19]Rev. Rul. 66-91 cannot be distinguished on the theory that the term "taxable income" has a special statutory meaning if the taxpayer is part of a consolidated group. For one thing, "consolidated taxable income" is itself computed by taking into account the "separate taxable income of each member of the group." See Treas. Regs. §1.1502-11(a)(1). Moreover, Treas. Reg. §1.1502-12 specifies in detail how the separate taxable income of each member of the group is to be computed. See also Treas. Regs. §1.1552-1 (determination of earnings and profits of each member of the group is made by reference to its own "taxable income"). Finally, the fact that every member of a consolidated group has its own "taxable income" is acknowledged, as it must be, by Rev. Rul. 66-91 itself, which specifies that the corporation had "taxable income" for 1961.

Regs. §1.172-4(b)(1)(ii), is a loose paraphrase of the second sentence of §172(b)(2); it offers no independent insight into the meaning of the statute. The other references in the government's brief are to Treas. Regs. §1.172-5(a)(1) and (3), which are even less informative. They amplify the statement in Treas. Regs. §1.172-5(a) that:

> "The taxable income for any taxable year . . . which is subtracted from the net operating loss for any other taxable year to determine the portion of such net operating loss which is a carryback or a carryover to a particular taxable year *is computed* with the modifications prescribed in this paragraph." (Emphasis added.)

But, as we pointed out earlier, neither we nor the courts dispute the mode of computing "taxable income," or the applicability of the modifications set out in the Regulations following the quoted statement. The issue before the Court is whether an NOL is to be reduced by the full amount of the "taxable income" (as thus computed), or only by a portion thereof. Nothing in Treas. Regs. §1.172-5(a)(1) or (3) even purports to deal with this issue.

Finally, the examples set out in the Treasury Regulations to illustrate the computation of the net operating loss deduction consistently present cases in which the "regular method" is used in computing tax liability for the years to which the NOL is carried. See Treas. Regs. §1.172-5(a)(3). Not once is there an example where the capital gain is large enough to bring the alternative tax computation into play, and where, under the government's present theory, there would be an NOL which would lead to no tax benefit. We have already

pointed out (fn. 11, pp. 28-29, *supra*) that the Treasury Regulations issued under the 1939 Code also avoided, in the same manner, any illustration of the result now contended for in the litigating position of the government.

Thus, for more than 30 years, the Treasury Regulations have failed to state explicitly the position only recently assumed by the government in litigation.

We should also point out that in the Regulations dealing with the carryback of capital losses and its interplay with §172 (Treas. Reg. §1.1212-1(a), examples 3 through 6) there is a similar, seemingly deliberate, avoidance of any examples involving use of the alternative tax in capital loss carryback years.

Taken together, these portions of the Treasury Regulations fail to support the government's theory in the very places where such support is to be expected, and by their consistent silence, they suggest a lack of faith at the administrative level in the construction now urged on this Court, and a failure to apprise the Congress that such was the view of the Treasury, if it really had such a view, prior to the present attempt to win the point by litigation.

G. The Statute Should Be Interpreted to Have a Substantive Result—Not One Which Is Purely Formalistic.

It is a salutary approach to the Internal Revenue Code to assume that Congress intended to deal with matters of substance, not with mere formalisms. This Court, and the lower courts, have repeated this principle with regularity. The classic case, of course, is *Gregory v. Helvering*, 293 U.S. 465 (1935) where the literal language of the statute would have compelled the conclusion that there was a nontaxable reorgani-

zation; but this Court rejected the contention that Congress intended to legislate in a formalistic manner, saying (p. 470) in language not inappropriate here:

> "To hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose."

This Court has always proceeded on the assumption that "Taxation is a practical matter . . ." (*Harrison v. Schaffner*, 312 U.S. 579, 582 (1941)) and that the taxing statute should be so approached. And where the overall intent of Congress to reach such a practical result is evident from the entire statutory scheme, the language of a particular section has received a broader interpretation than would follow if its literal language were the only insight into the congressional meaning. *Corn Products Refining Co. v. Commissioner*, 350 U.S. 46 (1956). Such an effort to discern the congressional intent is, of course, not limited by this Court to cases involving the Internal Revenue Code. See *United Housing Foundation Inc. v. Forman* (decided June 17, 1975); *Muniz v. Hoffman* (decided June 24, 1975).

The Tax Court applied these very principles in *Chartier* (52 T.C. at 358) when it rejected the Commissioner's interpretation as one which would "exalt form over substance."

The government approaches the statute with the single view that Congress was only concerned with the abstract definition of "net income." The practical question of how this would affect the tax burden is evidently considered by it to be so unimportant that the government never makes it explicit to this Court that its contentions would not result in a reduction of the tax

cost. We submit that the time honored principles of statutory construction require a different insight into the congressional intent and the conclusion that Congress meant the statute to operate in a meaningful way, not in the purely abstract manner urged by the government.

H. The Government's Contentions, Urged in Support of a Restrictive Interpretation of Section 172, Will Not Survive Analysis.

1. *The government's insistence on "parallel treatment" for the year in which the loss arose and the years to which a net operating loss is carried conflicts with an express, consistent congressional policy of treating these years differently.*

The government places great stress on the fact that, by virtue of §172(c), a net operating loss does not come into existence for a "loss" year if the business loss for that year is offset by capital gains of equal or greater amount. On this fact, which we do not dispute, the government rests the entire second half of its argument (Br. pp. 28-32). Its position is best summed up by the statement that (Br. p. 29): "the result should be the same" whether the capital gain takes place in one of the carry years or in the business loss year itself.

The unarticulated but critical premise on which this argument rests—"parallel treatment" between the years to which net operating losses are carried and the year in which the loss arose—is superficially appealing. It suffers from only one defect, but the defect is a fatal one: the premise has never been adopted by Congress.

The precise contrary is true. The legislative rules governing net operating losses have been altered many times since the ancestor of §172 was enacted in 1918, but one of the few constants in this sea of variables is that the year in which operating losses occur has repeatedly been treated by Congress differently from the years to which the loss is carried. Not only are the statutory provisions too clear and explicit to admit any doubt, but Congress has repeatedly, through its committee reports, made it clear that it intended no parallel treatment.[20]

For example, Code §172(d) lists certain modifications which, under §172(c) are to be made in the loss year to determine the amount, if any, of the net operating loss, but, in applying §172(b)(2), two of those modifications are not to be used.[21]

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[20]That Congress knew precisely that it was distinguishing between, and did not intend parallel treatment of, the loss year and the carry years is illustrated by the lengthy discussion in H. R. Rep. No. 1337, 83rd Cong., 2nd Sess. 27-28 (1954); S. Rep. No. 1622, 83rd Cong., 2nd Sess. 31-32 (1954); and H. R. Conf. Rep. No. 2543, 83rd Cong., 2nd Sess. 30-31 (1954).

[21]The government states or implies, more than once, that the "modifications" listed in §172(d) must be made in computing the taxable income of a year to which an NOL is carried (Br. 27). Though we regret burdening the Court with still more technical details, there is unfortunately no other way to correct this potentially misleading explanation of §172.

First, contrary to the government's assertion, §172(d) "requires" nothing; it simply *lists* certain "modifications." These adjustments are "required" by two other subsections of §172—§172(c), applicable only to the year in which the NOL arises, which has nothing to do with the years to which the NOL is carried; and the third sentence of §172(b)(2) which is concerned only with the amount of an NOL that can be carried from one of the carryback or carryover years to the next such year. There is *no* provision in §172 requiring any of §172(d)'s modifications to be made in the taxable year in which an NOL is used as a deduction.

A concrete example may clarify this complex statutory plan. If the taxpayer has a business loss of $15,000 and partially tax-exempt interest of $10,000 in 1975, its NOL would be only $5,000, because §172(c) requires the §172(d)(5) modification to be made in determining if the taxpayer has incurred an NOL and, if so, its amount. When this modification is made, the 1975 deductions exceed taxable income (as modified) by only $5,000, and this is the amount of the NOL. But if the partially tax-exempt interest had been received in 1972 rather than in 1975, the results would be quite different. The 1975 business loss would then create a $15,000 NOL, which would be carried back to 1972, where it could be deducted in full from taxable income despite the hypothesized 1972 partially tax-exempt interest. If—but only if—the NOL was not fully used in 1972, it would be reduced by the partially tax-exempt interest (by virtue of the third sentence of §172(b)(2)) in determining the amount to be carried to 1973. Thus, if the 1972 business income was $15,000, the NOL would be fully used to reduce this amount to zero (despite the taxpayer's receipt of $10,000 of partially tax-exempt interest in 1972), and there would be no occasion for making the modifications prescribed by the third sentence of §172(b)(2). But if the business income in 1972 had been $4,000, it would be reduced to zero by the 1975 NOL, the third sentence of §172(b)(2) would be brought into play, and only $1,000 of the NOL ($15,000 minus $4,000 and $10,000) would remain to be carried to 1973.

Thus, while §172(d)(6) actually deals with several modifications, we shall limit our discussion to only one of them as being illustrative, namely, the deduction for dividends received by corporations. Code §243(a) allows (with qualifications) a corporation to deduct 85% of dividends received from other corporations. A corporation having a loss year is, under the modification of §172(d)(6), allowed to deduct 100% of the dividends it receives in that year in computing the amount of its loss which it can carry to other years. However, Code §172 does not provide that this modification is to be made in the carryback or carryforward years. Thus, a corporation will have a different overall tax burden if it receives a dividend in the loss year than if it had received the same dividend in one of the carry years.

Again, in the case of an individual, the modifications required by §172(d)(4) are designed to pre-

vent non-business deductions from increasing the net operating loss attributable to a business (we eschew discussing the technical manner the statute follows in reaching this result). But this modification is not required during a carry year. Again, a taxpayer will have a different overall tax burden, depending on whether non-business deductions were incurred in the loss year or in a carry year.

In order not to prolong this discussion, we have put into Appendix B, *infra,* a table summarizing the various differences which the statute has made over the course of time between the computation of the loss year and the carryback or carryover years. The table amply demonstrates, contrary to the simplistic contention of the government, that Congress has never provided parallel treatment for the loss year and the years to which the loss is carried.

When the issue is approached from the undeniable fact the Congress intended differences between the loss year and the carry years, it is plain that the court below violated no settled congressional policy by permitting a deduction in 1967 for part of the 1968 loss, even though an NOL would not have arisen if the taxpayer's loss and capital gain had been sustained in the same year.

Finally, we emphasize that the government's view will *never* achieve its ostensible goal of parallelism: If the profitable year takes place before the capital gain year in the carry period, or even when they coincide, the NOL is deductible; however, if the capital gain is realized in the loss year, there is no NOL. Thus, even its view creates differences between the loss year and the carry years.[22]

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[22]See the discussion in Point I-D, *supra,* pages 32-38.

2. *The government's assertion that corporations would receive "markedly better treatment" than individuals under the decision below is not warranted.*

The government seems to assert that the *Chartier* rule would place corporations in a better position than individuals and, therefore, it contends that the Tax Court and the court below were wrong (Br. pp. 26-28). But the Tax Court, in dealing with an individual taxpayer, actually reached the same result as it previously did in *Chartier,* where a corporation was involved. *Axelrod v. Commissioner,* 32 T.C.M. 885 (1973). It is only because the Sixth Circuit reversed *Axelrod* (507 F.2d 884 (1975)) (erroneously as we shall show) that the government can point to differences where none truly exist.

This Court, of course, does not have a case involving an individual taxpayer before it and need not pass on the correctness of the Sixth Circuit's decision in *Axelrod, supra.* But because the government, assuming the correctness of *Axelrod,* asserts that (Br. p. 27) "an individual who used the alternative tax of Section 1201 (b) would be denied the very net operating loss carryover allowed to a corporation by the decision below," we are required to discuss the matter more at length than we desire, in order to dispel this erroneous suggestion of discrimination.

In charging discrimination, the government and *Axelrod* point to the modification described by §172(d)(2)(B)—the elimination of the deduction of long-

term capital gains for individuals—as justification for their ultimate position.

The short answer is that an individual, when using the alternative tax, *never is required to use the modification of Section 172(d)(2)(B)*. Neither is a corporation. There is not and need not be any difference in result, when the alternative tax is employed, between an individual and a corporation. The conclusion of the government (which cites but never analyzes the statute in this respect) that there is such a difference or that there need be one is demonstrably erroneous.

The provisions for taxing capital gain must first be examined. While Congress, where the alternative tax computation is to be used, ultimately reaches the same result of placing a flat rate of tax on long-term capital gains, whether realized by corporations or by individuals, it achieves this in a more convoluted way for individuals. § 1201(a), in the case of corporations, does it fairly simply; the amount of income subject to the normal tax is "reduced" by the amount of the capital gain, and the capital gain is then taxed at the flat rate of 25% (increased in years after 1969). The ordinary business income is taxed to all corporations alike. The tax on ordinary income plus the flat tax on capital gain are added together, and result in the total tax imposed.

When an individual (and we here pass over some other complexities of the statute) computes the tax under the *regular* method, there is a "deduction from gross income" (a deduction not available to corporations) of 50% of the net capital gain (Code Section 1202), with the result that only one-half of the capital gain is subject to tax under the *regular* method. When the *alternative* tax is applicable to an individual (because it is lesser), Code Section 1201(b) provides

that the normal tax applies to all income, after eliminating all capital gains income; it achieves this result by requiring that income shall "be reduced by 50 percent" of the gain (the other 50% having already been eliminated by the deduction of Section 1202); it then adds a 25% tax on the full amount of the net long-term capital gain to the regular tax on non-capital gain income. The deduction of Code §1202, quite clearly, is only meaningful when the *regular* method is used by individuals; *it has no significance when the alternative tax is used.*

Code §172(d)(2)(B) provides that one of the modifications applicable "to taxpayers other than corporations," is that the deduction afforded by §1202 for long-term capital gains shall not be allowed. But, when the alternative tax is computed for individuals, a flat rate of tax is imposed on the full amount of the capital gain (just as is true for corporations) and the §1202 deduction is not utilized. Therefore, if the alternative tax is applicable in the loss year, or in the carry year, or both, there is no deduction for capital gains in the computation and the §172(d)(2)(B) modification is not applicable. It is only applicable where the regular tax is imposed.

Turning now to the NOL provisions, under the *Chartier* construction of §172(b)(2), neither individuals nor corporations are disadvantaged by being required to reduce an NOL by capital gains that have been taxed in full under the alternative tax, for the NOL is still available as a deduction in other years. §172(d)(2)(B) does not alter this status of equality between individuals and corporations.

There is, therefore, no discrimination against individuals using the alternative tax. The government's

claim to the contrary is based on the erroneous assumption that individuals subject to the alternative tax are required to make a §172(d)(2)(B) adjustment that, in actuality, is applicable only when the regular method of computing tax is employed. It and the Sixth Circuit in *Axelrod, supra,* are plainly wrong in believing that inequality of treatment flows from the decision below.

3. *The government is wrong in contending that the decision below entails an improper "pyramiding" of tax benefits.*

The government asserts (Br. pp. 31-32) that the decision below allows a "pyramiding" of tax benefits. If this means only that the taxpayer was permitted to use two provisions of the Internal Revenue Code, the result is obviously no more objectionable than is a taxpayer's deduction of medical expenses and also of charitable contributions when both deductions are authorized by the Code.

But the pejorative implication of the term "pyramiding" is totally unwarranted. As a quick review of Table B indicates, the decision below results in taxing a total of $361,000 over the period 1966-68, which corresponds to the taxpayer's economic gain for that period. Moreover, the ordinary income component ($79,000) is taxed at the ordinary rate prescribed by Congress for ordinary income, while the long-term capital gain component ($282,000) is taxed at the rate prescribed by Congress for capital gains. The decision below, therefore, entails no improper "pyramiding" of tax benefits, but rather reaches the results intended by Congress.

The government's argument here, moreover, overlooks the plain fact that Congress has made two distinct policy decisions, neither having anything to do with the other directly. The NOL deduction, of course, is designed to iron out fluctuations in income. The alternative tax on capital gains results from complex economic considerations (too involved to be discussed in a few words[23]) respecting the disposition of capital assets. To contend that there is an erroneous "pyramiding" of benefits when both congressional policies are given effect, as they were by the court below, is to contend that only one, but not both of these policies, should be followed by the courts. Such a contention is plainly wrong.

Inadvertently, however, the government has raised a genuine issue. Under its theory, the taxpayer will be taxed on $35,000 more than its economic gain during the period 1966-68. *That,* we submit, is an improper "*pyramiding*" of income subject to tax.

4. *The repeal of the 1924-34 rules regarding computation of the alternative tax does not provide support for the government's construction of Section 172(b)(2).*

The court in the *Mutual Assurance* case, *supra,* thought that it found strong support for its construction of §172(b)(2) in the fact that Congress repealed the 1924-34 rules prescribing the method of computing the alternative tax on capital gains when the taxpayer had an excess of ordinary deductions over ordinary income in the same year. This excursion into ancient history proves nothing. We are not sure whether the government recognizes the defects of the reasoning in the

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[23]See, for example, U.S. Treasury Department, "Federal Income Tax Treatment of Capital Gains and Losses" (1951); Seltzer, "The Nature and Tax Treatment of Capital Gains" (1951).

Mutual Assurance decision; it seems to do so, for it relegates to a footnote a summary of that reasoning without an explicit endorsement. (See Br. p. 31, fn. 19.)

Plainly, the Fourth Circuit was wrongly persuaded by the bit of statutory history on which it relied. Briefly summarized, the 1924-34 legislation in question provided that the net operating losses of non-corporate taxpayers (the only ones subject, during those years, to an alternative tax on capital gains) were to be offset against the capital gains subject to the alternative tax. See Revenue Act of 1924, c. 234, §208(a)(5), 43 Stat. 253. From the repeal of this provision, relating to non-corporate taxpayers, for the offset of operating losses against capital gains of the same year when the alternative tax was applicable, the Fourth Circuit concluded (1) that subsequent legislation containing no such explicit direction should be construed to forbid an offset in these circumstances, (2) that when an NOL is carried to an alternative tax year, it should not be offset against the capital gains of that year, and (3) finally, that when the NOL is carried from the capital gain year to the following year, it must be reduced by the capital gains even though it does not affect the alternative tax paid thereon.

The first negative inference in the foregoing chain of reasoning was accepted in the *Weil* case; the second, in the first part of the *Chartier* case. Whether the repeal of the 1924-34 legislation warrants these two negative inferences or not, they are at least closely linked to the 1924-34 rules.

The third negative inference (which is, of course, the issue to be decided by this Court), however, is far removed from the 1924-34 rules, both in time and in

logic. For ought that appears, Congress may have repealed the 1924-34 rules for non-corporate taxpayers (or refrained in later years from reinstating them) in order *to increase* the circumstances in which business losses will be offset against ordinary income, rather than to diminish that possibility. For this reason, quite aside from the numerous other statutory changes that make it perilous to draw conclusions from the repeal of obsolete legislation, the abandonment of the 1924-1934 rules does not provide support for the government's construction of §172(b)(2).

II.

The Tax Court's Construction of Technical Provisions of the Internal Revenue Code, Unless Clearly Erroneous, Should Be Given Great Weight by the Federal Courts of General Jurisdiction.

This case involves nothing more than the proper construction of narrowly technical provisions of the Internal Revenue Code, on which the Tax Court has reached the same conclusion as the court below on four occasions. The issue immediately before the Court is colored by a series of other technical issues, including the proper computation of the alternative tax for the prior year, the relationship between individual taxpayers and corporations, the operation of the capital loss carryback, and even the right of a taxpayer in special circumstances to use the alternative tax method even if it produces a higher tax than the regular method.[24]

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[24]See *Lone Manor Farms, Inc. v. Commissioner*, 61 T.C. 436 (1974), aff'd January 27, 1975 by the Third Circuit in an unpublished opinion, holding that §1201 does not permit the taxpayer to use the "alternative method" when it will produce a higher tax liability than the regular method, even if

(This footnote is continued on next page)

Where complex details of the taxing statute and the minutiae of legislative history must be explored, we submit that the Tax Court, by virtue of its specialized jurisdiction and daily immersion in the Internal Revenue Code and Treasury Regulations, is better situated than the federal courts of general jurisdiction to arrive at a correct conclusion.[25] Decisions like these, important though they are to the parties, do not establish or modify important principles of tax law, nor do they shed any light on other areas of the law. Indeed, one can hardly conjure up a question of less general importance than the one that is now before the Court.

If the Fourth Circuit, in *Mutual Assurance, supra* (a case where so little was involved that the taxpayer did not seek review by this Court) had placed greater

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the taxpayer would thereby preserve a net operating loss for use in another year. The case involves difficult questions under §6214(b) (prescribing the jurisdiction of the Tax Court) and the statute of limitations, as well as under §1201 and §172. For these reasons, the *Lone Manor Farms* case can hardly serve to support the government's position in the case at bar (as suggested by its Brief p. 33, n. 22), unless this Court is prepared to determine the validity of the Tax Court's holding without briefs and arguments on these complex issues. As we urge, however, acceptance of the Tax Court's determination in such technical cases would leave standing the principles established by both *Lone Manor Farms, Inc.* and *Chartier*.

[25]See the comment of Mr. Justice Jackson in *Arrowsmith v. Commissioner*, 344 U.S. 6, 10 (1952) (dissent), regarding the Tax Court's ability to work its way through "a field beset with invisible boomerangs," quoted with seeming approval by Mr. Justice Stewart, in his Remarks at the dedication of the Tax Court's new courthouse, 28 Tax Lawyer 451, 453 (1975).

In the same issue of the publication, in an article which reviews the *Chartier* problem, the conclusion is reached that the *Chartier* line of cases "are more soundly based on the policy underlying the favorable treatment of capital gains" and that the rationale attempted by the Fourth and Sixth Circuits "should not stand in the way of the sound policy of *Chartier* and the cases that have followed it." Branda, *Net Operating Losses and Capital Gains—Some Bizarre Consequences of the Alternative Tax Computation*, 28 Tax Lawyer 455, 470 (1975).

reliance on the expertise of the Tax Court, and had not thought that it had found a new insight into the congressional meaning, the present conflict in decisions would not have arisen and another case would not have been needlessly added to this Court's heavy docket.

We urge that in cases of this character, the Tax Court's construction of technical provisions of the Internal Revenue Code, unless clearly erroneous, should be given great weight by the federal courts of general jurisdiction.[26] In urging this point, we do not suggest that the Tax Court is in any sense better equipped than the other federal courts to decide all tax cases, or that it has a monopoly on judicial wisdom. In many tax cases, the technical issues are subservient to broader legal principles, and are illuminated by the breadth of experience that courts of general jurisdiction gain from their diversified caseloads. But the indispensable contribution of these courts to the resolution of important tax cases is inevitably diluted by the demands of cases that require time-consuming inquiries into technical details that have no significance beyond their own ambit.

III.

If the Decision Below Is Reversed, the Principle Decided in Weil v. Commissioner, as Applied in the Chartier Case, Should Be Rejected.

The court below, and both the government and the taxpayer before this Court, have assumed that in recomputing its 1966 tax liability under the alternative

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[26]This principle would not entail a revival of *Dobson v. Commissioner*, 320 U.S. 489 (1943), or a violation of the "clearly erroneous" rule of §7482(a) of the Internal Revenue Code, enacted in 1948. Our proposal is limited to interpretations of technical provisions of the Internal Revenue Code that are not clearly erroneous.

method, the taxpayer was not permitted to apply its 1968 NOL carryback against its long-term capital gains. As we have pointed out, this construction of §1201(a)(2) originated with *Weil v. Commissioner* and was applied explicitly to corporations with NOL carrybacks in the first part of the *Chartier* case (*supra*, p. 15). When the Tax Court went on in *Chartier* to hold that the NOL had not been reduced by the application of the *Weil* principle and was still available under the "carried" language of §172(b)(2), it obviously (and, we submit, properly) regarded the two issues as interrelated aspects of a single harmonious statutory framework.

If this Court should adopt the construction of §172(b)(2) urged by the government and reverse the court below, we urge the Court to re-examine, and reject, the *Weil* principle. We submit that the only rational basis for accepting the government's construction of §172(b)(2) is that (contrary to the *Weil* principle) the NOL was available in 1966 to reduce the amount of capital gains subject to tax.

The effect of rejecting *Weil* would be that the net loss sustained by business operations, even though not reducing the higher tax on business income during 1967, would at least be available to recoup the 25 percent tax paid on the 1966 capital gains, rather than disappearing altogether. A rejection of the *Weil* principle would also reduce the bizarre consequences of timing that we have illustrated earlier (*supra*, pp. 32-40) by permitting business losses to be applied against both ordinary income and capital gain (a) whether tax liability is computed under the regular or alternative method, (b) whether the capital gains are realized in the same year as the business losses or in a year to which the

losses are carried under §172, and (c) in the latter circumstances, regardless of the chronological order in which the taxpayer happens to realize its ordinary income and capital gains, or even a capital loss.

We frankly admit that the language of §1201(a)(2), standing alone, supports the result reached in *Weil* and applied in *Chartier* (first issue). But if the closely related second issue in *Chartier* is decided as the government here urges, the statutory language of §1201(a)(2) should not be accepted as conclusive, in view of the consequences it would then have. Indeed, the Tax Court might have overruled *Weil* in *Chartier* if it had been convinced that Congress intended the NOL to be absorbed by the capital gains of the prior year in all circumstances.

It should be noted that, in other situations, the Courts of Appeals have refused to apply the plain implications of *Weil*, when convinced that it would lead to a result not contemplated by Congress. Thus, in *Statler Trust v. Commissioner*, 361 F.2d 128 (2d Cir. 1966), the court (District Judge Dooling dissenting), rejected the argument that a trust which had made a capital gain distribution to charities was not entitled to a deduction for such distribution when computing its capital gain tax liability under the alternative method. The Court refused to accept the Commissioner's argument (resting on *Weil*) that a deduction is not permitted to reduce the amount of capital gain subject to the alternative tax. Speaking for the Court, Judge Friendly said (at p. 131):

> "The argument stresses the form at the neglect of substance; the letter of §1201(b) must yield when it would lead to an unfair and unintended result. See Read v. United States, 320 F.2d 550 (5th Cir. 1963)."

After examining the congressional purpose in providing deductions for trust distributions to charity, the court went on to say (p. 132):

> "Thus the literal reading of §1201(b) urged by the Commissioner would not only be inconsistent with the general scheme of trust taxation but would bring about adverse results with respect to charitable gifts that Congress is unlikely to have intended."

The circumstances here are parallel. The net operating loss, if it is to be treated as "absorbed" by the capital gain, should be allowed to reduce that capital gain. Even if the language of the statute, standing alone, suggests a different answer, it ought to yield to the basic legislative purpose of having the net operating loss serve the function of permitting "a taxpayer to set off its lean years against its lush years" (*Libson Shops, Inc. v. Koehler, supra,* p. 21).

Again, in *Read v. United States,* 320 F.2d 550 (5th Cir. 1963), the United States contended that, under the doctrine of *Weil,* a deduction under §691(c) (for federal estate taxes paid on income in respect of a decedent) was not available to reduce the amount of capital gain where the alternate tax computation is used. The Court said (pp. 552-553):

> "The Government argues that since there is no express provision making the deduction applicable in alternative tax computations, it is clear and certain that the deduction cannot be taken. The executrix, with like logic, contends that the deduction is permitted and if it were to be withheld in capital gains taxation the statute would have said so. We profit but little from such reasoning. We do not think it can be said that the language of the statute is of itself decisive of the question.
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> * * *
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> To adopt the Government's view would result in the imposition of both estate and income tax on the income amounts where the alternative computation was used. There is no more reason to suppose that Congress intended such a result than to suppose that it intended that the right to use the deduction in the alternative method of computation in respect of such income should be allowed.
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> * * *
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> The offsetting is a *pro tanto* cancelling out. It works a reduction in the amount of the particular kind of income which is to be subject to taxation. There is equal purpose to be served and a like reason for allowing the deduction where the alternative tax computation is used as where it is not. The decision of the Court is reversed and the proceeding is remanded for a redetermination of the tax under the principle here stated."

In the words of the Fifth Circuit, we submit that there is an "equal purpose" to be served by the net operating loss deduction, whether the taxpayer is subject to the regular or the alternative tax computation in the carryback year. See also *Meissner v. United States,* 364 F.2d 409 (Ct. Cl. 1966), which not only followed *Read,* but went further to hold that §691(c) deductions could be applied against ordinary income as well as capital gains. Agreeing with *Read* that the statute was susceptible of several interpretations so that an inquiry into its legislative purpose was required, the court said (364 F.2d at 414) "allowing [the deduction]

under both steps of the alternative tax computation in a way that is most advantageous to a taxpayer best gives effect to this [legislative] purpose, and the text of the statute is consistent with this approach." Substantially the same point can be made about §1201 (a)(1) if the Court reverses the decision below.

Finally, we recognize that the 1966 capital gain year is not before the Court, so that the application of *Weil* is not a precise issue. But if the decision below is reversed, we suggest that the only plausible reasoning which would lead to such a conclusion would involve a rejection of the *Weil* principle and, in such an event, it would be appropriate that the rejection be made clear in the Court's opinion.

Conclusion.

For all the reasons which have been stated, the decision below should be affirmed. Alternatively, the principle embodied in *Weil v. Commissioner,* 23 T.C. 424, aff'd 229 F.2d 593 (6th Cir. 1956) should be rejected.

Respectfully submitted,

HILBERT P. ZARKY,
BORIS I. BITTKER,
Counsel for Data Products Corporation.

Of Counsel:
MITCHELL, SILBERBERG & KNUPP.

APPENDIX A.

Statute and Regulations.

Internal Revenue Code of 1954 (26 U.S.C.):

Sec. 11 [as amended by Sec. 121, Revenue Act of 1964, P.L. 88-272, 78 Stat. 19, 25]. Tax Imposed.

(a) *Corporations in General.*—A tax is hereby imposed for each taxable year on the taxable income of every corporation. The tax shall consist of a normal tax computed under subsection (b) and a surtax computed under subsection (c).

(b) *Normal Tax.*—The normal tax is equal to the following percentage of the taxable income:

* * *

(2) 22 percent, in the case of a taxable year beginning after December 31, 1963.

(c) *Surtax.*—The surtax is equal to the following percentage of the amount by which the taxable income exceeds the surtax exemption for the taxable year:

* * *

(3) 26 percent, in the case of a taxable year beginning after December 31, 1964.

(d) *Surtax Exemption.*—For purposes of this subtitle, the surtax exemption for any taxable year is $25,000. * * *

* * *

Sec. 63. Taxable income defined.

(a) *General Rule.*—Except as provided in subsection (b), for purposes of this subtitle the term "taxable income" means gross income, minus the deductions allowed by this chapter, other than

the standard deduction allowed by part IV (sec. 141 and following).

* * *

Sec. 172. Net operating loss deduction.

(a) *Deduction Allowed.*—There shall be allowed as a deduction for the taxable year an amount equal to the aggregate of (1) the net operating loss carryovers to such year, plus (2) the net operating loss carrybacks to such year. For purposes of this subtitle, the term "net operating loss deduction" means the deduction allowed by this subsection.

(b) [as amended by Sec. 317(b), Trade Expansion Act of 1962, P.L. 87-794, 76 Stat. 872, 889, and Secs. 210(a) and 210(b), Revenue Act of 1964, P.L. 88-272, 78 Stat. 47-49] *Net Operating Loss Carrybacks and Carryovers.*—

(1) *Years to which loss may be carried.*—

(A)(i) Except as provided in clause (ii) and in subparagraph (D), a net operating loss for any taxable year ending after December 31, 1957, shall be a net operating loss carryback to each of the 3 taxable years preceding the taxable year of such loss.

* * *

(B) Except as provided in subparagraphs (C) and (D), a net operating loss for any taxable year ending after December 31, 1955, shall be a net operating loss carryover to each of the 5 taxable years following the taxable year of such loss.

* * *

(2) *Amount of carrybacks and carryovers.*—Except as provided in subsections (i) and (j),

the entire amount of the net operating loss for any taxable year (hereinafter in this section referred to as the "loss year") shall be carried to the earliest of the taxable years to which (by reason of paragraph (1)) such loss may be carried. The portion of such loss which shall be carried to each of the other taxable years shall be the excess, if any, of the amount of such loss over the sum of the taxable income for each of the prior taxable years to which such loss may be carried. For purposes of the preceding sentence, the taxable income for any such prior taxable year shall be computed—

(A) with the modifications specified in subsection (d) other than paragraphs (1), (4) and (6) thereof; and

(B) by determining the amount of the net operating loss deduction—

(i) without regard to the net operating loss for the loss year or for any taxable year thereafter, and

(ii) without regard to that portion, if any, of a net operating loss for a taxable year attributable to a foreign expropriation loss, if such portion may not, under paragraph (1)(D), be carried back to such prior taxable year,

and the taxable income so computed shall not be considered to be less than zero. * * *

(c) *Net Operating Loss Defined.*—For purposes of this section, the term "net operating loss" means (for any taxable year ending after December 31, 1953) the excess of the deductions allowed by this chapter over the gross income.

Such excess shall be computed with the modifications specified in subsection (d).

(d) [as amended by §7, P.L. 87-792, 76 Stat. 829] Modifications.—The modifications referred to in this section are as follows:

(1) Net Operating Loss Deduction.—No net operating loss deduction shall be allowed.

(2) Capital Gains and Losses of Taxpayers Other Than Corporations.—In the case of a taxpayer other than a corporation—

(A) the amount deductible on account of losses from sales or exchanges of capital assets shall not exceed the amount includible on account of gains from sales or exchanges of capital assets; and

(B) the deduction for long-term capital gains provided by section 1202 shall not be allowed.

(3) Deduction for Personal Exemptions.—No deduction shall be allowed under section 151 (relating to personal exemptions). No deduction in lieu of any such deduction shall be allowed.

(4) Nonbusiness Deductions of Taxpayers Other Than Corporations.—In the case of a taxpayer other than a corporation, the deductions allowable by this chapter which are not attributable to a taxpayer's trade or business shall be allowed only to the extent of the amount of the gross income not derived from such trade or business. For purposes of the preceding sentence —

(A) any gain or loss from the sale or other disposition of—

(i) property, used in the trade or business, of a character which is subject to the al-

lowance for depreciation provided in section 167, or

(ii) real property used in the trade or business, shall be treated as attributable to the trade or business;

(B) the modifications specified in paragraphs (1), (2)(B), and (3) shall be taken into account;

(C) any deduction allowable under section 165(c)(3) (relating to casualty losses) shall not be taken into account; and

(D) any deduction allowed under section 404 or section 405(c) to the extent attributable to contributions which are made on behalf of an individual who is an employee within the meaning of section 401(c)(1) shall not be treated as attributable to the trade or business of such individual.

(5) Special Deductions for Corporations.—No deduction shall be allowed under section 242 (relating to partially tax-exempt interest) or under section 922 (relating to Western Hemisphere trade corporations).

(6) Computation of Deduction for Dividends Received, etc.—The deductions allowed by sections 243 (relating to dividends received by corporations), 244 (relating to dividends received on certain preferred stock of public utilities), and 245 (relating to dividends received from certain foreign corporations) shall be computed without regard to section 246 (b) (relating to limitation on aggregate amount of deductions); and the deduction allowed by section 247 (relating to dividends

paid on certain preferred stock of public utilities) shall be computed without regard to subsection (a) (1) (B) of such section.

Sec. 1201. Alternative tax.

(a) [as amended by Sec. 8(g)(3), Revenue Act of 1962, P.L. 87-834, 76 Stat. 960, 999] *Corporations.*—If for any taxable year the net long-term capital gain of any corporation exceeds the net short-term capital loss, then, in lieu of the tax imposed by sections 11, 511, 821(a) or (c), and 831(a), there is hereby imposed a tax (if such tax is less than the tax imposed by such sections) which shall consist of the sum of—

(1) a partial tax computed on the taxable income reduced by the amount of such excess, at the rates and in the manner as if this subsection had not been enacted, and

(2) an amount equal to 25 percent of such excess, or, in the case of a taxable year beginning before April 1, 1954, an amount equal to 26 percent of such excess.

In the case of a taxable year beginning before April 1, 1954, the amount under paragraph (2) shall be determined without regard to section 21 (relating to effect of change of tax rates).

(b) *Other taxpayers.* If for any taxable year the net long-term capital gain of any taxpayer (other than a corporation) exceeds the net short-term capital loss, then, in lieu of the tax imposed by sections 1 and 511, there is hereby imposed a tax (if such tax is less than the tax imposed by such sections) which shall consist of the sum of—

(1) a partial tax computed on the taxable income reduced by an amount equal to 50 percent of such excess, at the rate and in the manner as if this subsection had not been enacted, and

(2) an amount equal to 25 percent of the excess of the net long-term capital gain over the net short-term capital loss.

Sec. 1202. Deduction for capital gains.

In the case of a taxpayer other than a corporation if for any taxable year the net long-term capital gain exceeds the net short-term capital loss, 50 percent of the amount of such excess shall be a deduction from gross income. In the case of an estate or trust, the deduction shall be computed by excluding the portion (if any), of the gains for the taxable year from sales or exchanges of capital assets, which, under sections 652 and 662 (relating to inclusions of amounts in gross income of beneficiaries of trusts), is includible by the income beneficiaries as gain derived from the sale or exchange of capital assets.

Sec. 1212. [As Amended by §513, Tax Reform Act of 1969, P.L. 91-172, 83 Stat. 638-642]. Capital Loss Carrybacks and Carryovers.

(a) CORPORATIONS.—

(1) IN GENERAL.—If a corporation has a net capital loss for any taxable year (hereinafter in this paragraph referred to as the "loss year"), the amount thereof shall be—

(A) a capital loss carryback to each of the 3 taxable years preceding the loss year, but only to the extent—

(i) such loss is not attributable to a foreign expropriation capital loss, and

(ii) the carryback of such loss does not increase or produce a net operating loss (as defined in section 172(c)) for the taxable year to which it is being carried back; and

(B) a capital loss carryover to each of the 5 taxable years (10 taxable years to the extent such loss is attributable to a foreign expropriation capital loss) succeeding the loss year,

and shall be treated as a short-term capital loss in each such taxable year. The entire amount of the net capital loss for any taxable year shall be carried to the earliest of the taxable years to which such loss may be carried, and the portion of such loss which shall be carried to each of the other taxable years to which such loss may be carried shall be the excess, if any, of such loss over the total of the net capital gains for each of the prior taxable years to which such loss may be carried. For purposes of the preceding sentence, the net capital gain for any such prior taxable year shall be computed without regard to the net capital loss for the loss year or for any taxable year thereafter. In the case of any net capital loss which cannot be carried back in full to a preceding taxable year by reason of clause (ii) of subparagraph (A), the net capital gain for such prior taxable year shall in no case be treated as greater than the amount of such loss which can be carried back to such preceding taxable year upon the application of such clause (ii).

* * *

(b) OTHER TAXPAYERS.—

(1) In General.—If a taxpayer other than a corporation has a net capital loss for any taxable year—

(A) the excess of the net short-term capital loss over the net long-term capital gain for such year shall be a short-term capital loss in the succeeding taxable year, and

(B) the excess of the net long-term capital loss over the net short-term capital gain for such year shall be a long-term capital loss in the succeeding taxable year.

(2) Special Rules.—

(A) For purposes of determining the excess referred to in paragraph (1)(A), an amount equal to the amount allowed for the taxable year under section 1211(b)(1)(A), (B), or (C) shall be treated as a short-term capital gain in such year.

(B) For purposes of determining the excess referred to in paragraph (1)(B), an amount equal to the sum of—

(i) the amount allowed for the taxable year under section 1211(b)(1)(A), (B), or (C), and

(ii) the excess of the amount described in clause (i) over the net short-term capital loss (determined without regard to this subsection) for such year,

shall be treated as a short-term capital gain in such year.

Treasury Regulations on Income Tax (1954 Code) (26 C.F.R.).

§ 1.172-1. Net operating loss deduction—(a) *Allowance of deduction.* Section 172(a) allows as a deduction in computing taxable income for any taxable year subject to the Code the aggregate of the net operating loss carryovers and net operating loss carrybacks to such taxable year. This deduction is referred to as the net operating loss deduction. The net operating loss is the basis for the computation of the net operating loss carryovers and net operating loss carrybacks and ultimately for the net operating loss deduction itself. The net operating loss deduction shall not be disallowed for any taxable year merely because the taxpayer has no income from a trade or business for the taxable year.

(b) *Steps in computation of net operating loss deduction.* The three steps to be taken in the ascertainment of the net operating loss deduction for any taxable year subject to the Code are as follows:

(1) Compute the net operating loss for any preceding or succeeding taxable year from which a net operating loss may be carried over or carried back to such taxable year.

(2) Compute the net operating loss carryovers to such taxable year from such preceding taxable years and the net operating loss carrybacks to such taxable year from such succeeding taxable years.

(3) Add such net operating loss carryovers and carrybacks in order to determine the net operating loss deduction for such taxable year.

* * *

(d) *Ascertainment of deduction dependent upon net operating loss carryback.* If the taxpayer is entitled in computing his net operating loss deduction to a carryback which he is not able to ascertain at the time his return is due, he shall compute the net operating loss deduction on his return without regard to such net operating loss carryback. When the taxpayer ascertains the net operating loss carryback, he may within the applicable period of limitations file a claim for credit or refund of the overpayment, if any, resulting from the failure to compute the net operating loss deduction for the taxable year with the inclusion of such carryback; or he may file an application under the provisions of section 6411 for a tentative carryback adjustment.

(e) *Law applicable to computations*—(1) *General.* The following rules shall apply to all taxable years without regard to whether they began before, on, or after January 1, 1954:

(i) In determining the amount of any net operating loss carryback or carryover to any taxable year, the necessary computations involving any other taxable year shall be made under the law applicable to such other taxable year.

(ii) The net operating loss for any taxable year shall be determined under the law applicable to that year without regard to the year to which it is to be carried and in which, in effect, it is to be deducted as part of the net operating loss deduction. In applying this rule, however, certain taxable years subject to the Internal Revenue Code of 1939 shall, to the extent provided in paragraphs (a) and (c) of § 1.172-2 and paragraphs (a) and (e) of § 1.172-3, be treated as though subject to the Internal Revenue Code of 1954.

(iii) The amount of the net operating loss deduction which shall be allowed for any taxable year shall be determined under the law applicable to that year.

* * *

§ 1.172-2. Net operating loss in case of a corporation.—(a) *Modification of deductions.* A net operating loss is sustained by a corporation in any taxable year beginning after December 31, 1953, if and to the extent that, for such year, there is an excess of deductions allowed by chapter 1 of the Internal Revenue Code of 1954 over gross income computed thereunder; this rule shall apply even though the loss year is otherwise subject to the Internal Revenue Code of 1939. In determining the excess of deductions over gross income for such purpose—

(1) *Items not deductible.* No deduction shall be allowed under—

(i) Section 172 for the net operating loss deduction,

(ii) Section 242 in respect of partially tax-exempt interest, and

(iii) Section 922 in respect of Western Hemisphere trade corporations;

(2) *Dividends received.* The 85-percent limitation provided by section 246(b) shall not apply to the deductions otherwise allowed under—

(i) Section 243(a) in respect of dividends received from domestic corporations,

(ii) Section 244 in respect of dividends received on preferred stock of public utilities, and

(iii) Section 245 in respect of dividends received from foreign corporations; and

(3) *Dividends paid.* The deduction granted by section 247 in respect of dividends paid on the preferred

stock of public utilities shall be computed without regard to subsection (a)(1)(B) of that section.

§ 1.172-4. Net operating loss carrybacks and net operating loss carryovers.—(a) *General provisions*—(1) *Years to which loss may be carried*—(i) *In general.* In order to compute the net operating loss deduction the taxpayer must first determine the part of any net operating losses for any preceding or succeeding taxable years which are carrybacks or carryovers to the taxable year in issue.

* * *

(3) *Amount of loss to be carried.* The amount which is carried back or carried over to any taxable year is the net operating loss to the extent it was not absorbed in the computation of the taxable (or net) income for other taxable years, preceding such taxable year, to which it may be carried back or carried over. For the purpose of determining the taxable (or net) income for any such preceding taxable year, the various net operating loss carryovers and carrybacks to such taxable year are considered to be applied in reduction of the taxable (or net) income in the order of the taxable years from which such losses are carried over or carried back, beginning with the loss for the earliest taxable year.

* * *

(b) *Portion of net operating loss which is a carryback or a carryover to the taxable year in issue*—(1) *Manner of computation.* (i) A net operating loss shall first be carried to the earliest of the several taxable years for which such loss is allowable as a carryback or a carryover, and shall then be carried to the next earliest of such several taxable years, etc. Except

as provided in § 1.172-11, the entire net operating loss shall be carried back to such earliest year.

(ii) The portion of the loss which shall be carried to any of such several taxable years subsequent to the earliest taxable year is the excess of such net operating loss over the sum of the aggregate of the taxable incomes (computed as provided in § 1.172-5) for all of such several taxable years preceding such subsequent taxable year which are subject to the Internal Revenue Code of 1954 and the aggregate of the net incomes computed as provided in 26 C. F. R. (1939) 39.122-4 (c) (Regulations 118) or in the corresponding section of prior applicable regulations) for all of such preceding taxable years which are subject to the Internal Revenue Code of 1939.

APPENDIX B.

The following adjustments to taxable or net income were required in the year of loss but not in the year of carryback or carryover under the respective Revenue Act sections in effect for the years noted below.

ADJUSTMENTS	1918-1920	1921-1923	1924-1927	1928-1932	1938	1939-1953	1954-1962	1963-Present
Excess of tax exempt interest over non deductible interest expense added back.	§204(a)	§204(a)	§206(a)(5)	§117(a)(5)	§26(c)(2)(B)			
Excess of non business deductions over non business gross income added back.	§204(a)	§204(a)	§206(a)(1)	§117(a)(1)		§122(d)(5)	§172(d)(4)	§172(d)(4)
Corporate dividends received deduction added back.		§204(a)	§206(a)(4)	§117(a)(4)				
Depletion in excess of cost added back.		§204(a)	§206(a)(3)	§117(a)(3)	§26(c)(2)(A)			
Capital loss deduction limited to amount of capital gains.			§206(a)(2)	§117(a)(2)				
Deductions for certain corporate dividends received or paid allowed without limitation.							§172(d)(6)	§172(d)(6)
Qualified retirement plan contributions for owner employee added back.								§172(d)(4)(D)